

K. R. Bopp prepared outline.

Material in parentheses are notes he made on his copy when leading the discussion at the Presidents' Conference on March 1, 1955.

Hap - You have asked for an informal discussion. I appreciate your invitation. I wish I had answers, but I do not communicate with any burning bush.

Leif  
Allan  
Al  
Wilbur  
Hugh  
Malcolm  
Hap  
DC  
Oliver  
Gavin  
Bob  
Cecil

## CONFERENCE OF PRESIDENTS OF THE FEDERAL RESERVE BANKS

March 1, 1955

### THE DISCOUNT RATE AND ITS RELATIONSHIP TO THE CREDIT MARKETS

Hap - It is a pleasure to introduce discussion - informal.  
From time to time I have talked with you - may call on you.

#### Outline of Introduction to the Discussion

##### I. Historical background

- establish F.R. Banks  
discount com'l paper  
elastic currency  
supervision)
- perhaps inevitable  
but tragic)
- have been on committees  
working on these matters -  
and have squirmed!  
but we all have a job  
to do
- A. Initially discounting was considered the most important function of the Federal Reserve Banks (both for itself and to provide an elastic currency) and the discount rate was considered the most important tool.
  - B. During the 1920's open market operations were given an increasingly significant role and became, in fact, the primary tool. (or at least equally important as discounting and the rate)
  - C. While Government security prices were pegged, emphasis was shifted to changes in reserve requirements. (An inevitable but tragic interlude)
  - D. With the Accord, the System began a systematic reappraisal of all instruments.
    1. Open market operations - almost immediately (Committee report published in Flanders Hearings)
    2. With the flurry in discounting during the period of restraint in 1952 and 1953, attention was directed to the discount rate and the discount mechanism. (Led to Revised Reg. A - in its initial draft and final draft  
That concerns the rules or administration)

(What is peculiar about discounting?)

##### II. /A crucial feature of discounting - and its implication

- A. Discounting is the chief means by which member banks may take the initiative in influencing the volume of reserves (or excess reserves) with which they operate.

Other factors that determine the volume of reserves are largely beyond the influence of the member banks: currency, gold, float, Treasury balances, the open market portfolio, reserve requirements.

- B. We can't say much that is very useful about the rate until we have decided how important we want discounting to be and the degree to which we want to regulate it through administration of rules.

We shall come back to each! This is merely presenting the spectrum.

- 2 -

There are real people who favor each degree

The Range or Spectrum of emphasis - I shall be Devil's advocate at times!

III. Alternative degrees of emphasis on discounting - with some implications for rate policy

- A. All credit is via discounting - extreme! (The only avenue - outside of
- A. Discounting as a major means of providing the market gold!)  
with reserves.

1. During the 1920's when the level of member bank reserves was \$2-\$2½ billion, the volume of borrowing was usually above \$½ billion and reached more than \$1 billion in 1928-29, so that members as a whole were generally borrowing from 20 to 25 per cent (at least) or more of their required reserves.

At the present time the level of required reserves is \$18-\$20 billion.

2. This decision would envision a sizable amount of borrowing at all times with rather wide fluctuations to accommodate the seasonal flows of currency, etc.
3. Some pros:
  - (a) One of the four enumerated purposes of the Federal Reserve Act is "to afford means of rediscounting" - "commercial paper" to be sure, but still rediscounting.
  - (b) Would tie member banks more closely to Reserve Banks.
  - (c) Would put funds into the banking system directly where they are needed rather than in the central money market. (in the hope that they would trickle out where needed)
4. Some cons:
  - (a) Will destroy the "tradition against borrowing" - a desirable characteristic for bankers to have.
  - (b) In view of the liquidity habits of banks and the tradition against borrowing, this state of affairs could not be brought about over night.
  - (c) It really can't be done - will have continual contractive effect and reduced availability of credit.
  - (d) Will reduce ability of System to make fine adjustments.
  - (e) Borrowing will be subject to widespread abuse.
  - (f) Difficult or impossible to police impartially.

Even if desirable

(If it can be done

5. Implications for the rate

Rate would have to be placed and kept relatively low in the galaxy of rates.

B. Discounting as a principal method of influencing the availability of credit.

1. The volume of discounting would virtually disappear in periods of active ease and might rise - to perhaps \$2 billion - in periods of active restraint.
2. Some pros:
  - (a) Makes use of the tradition against borrowing.
  - (b) Essentially what the System has done in the past.
3. Some cons:
  - (a) Gives discounting too small a role - or alternatively - too large a role.

ally what was done in the  
1920's - and  
more recently.  
stability of total reserves  
Nict → Open Market portfolio

4. Implications for the rate
  - (a) Really makes open market operations the primary instrument.
  - (b) Rate would lag behind changes in market rates and would be changed relatively infrequently.

C. Discounting as a method of daily adjustment. (Has never been discussed. Harold Roelse)

1. Open market operations are not adaptable to day to day adjustments.
  - (a) Although they can be made in amounts precisely specified in advance,
  - (b) There is no way to determine accurately how large they should be.

neral notion that they  
re very flexible - text-  
books say so - we know.

2. Discounts are available precisely where and to the extent they are needed - and allowed by the System.
3. Would be integrated with more extensive use of repurchase agreements.
4. Implications for the rate

magic in the rate (its  
relation to market rates)  
lther. Policy - should  
e tighten or ease and how  
uch - is still the problem!  
t is not answered by technics!  
here do you want to go?

The rate would have to be kept close to market rates - which in turn, however, are greatly influenced by open market operations. This might imply that closer attention be paid to market rates (as contrasted with the volume of free reserves) in determining open market operations.

Even so, changes in rate would probably be more frequent than in recent years.

concerting - but reason your job  
s more valuable - your abilities  
re scarce than Congressmen!

D. Limit borrowing to real emergencies

Evil's Advocate

The "real" problem is  
control of  $M + M^1$  as  
such - there are too many  
sudden and gradual changes  
in the demand for cash  
balances (e.g. Korea - or  
reverse June 1, 1953!) The  
real problem is control of  
the terms under which this  
demand can be satisfied.  
That is essentially the rate  
of interest. Permit tighten-  
ing with Korea - but not  
(June 1, 1953)

1. So long as member banks can take the initiative in borrowing, they can escape any pressure the System wishes to impose. (E. S. Shaw in "Money, Income and Monetary Policy", p. 214, says: "Rediscount is a breach in the armament of monetary control... Unless rediscount is restrained, monetary control is a fiction.")
2. Discounting would normally be at very low levels with the discount window kept open essentially to discharge the responsibility of "lender of last resort."
3. Implications for the rate

Rate always high relative to market rates -  
and possibly tight administration of rules  
as well.

IV. Implications of recent rate history (What would an historian say?)

Think of our actions - not in terms of politics - but in terms of history!

- A. Until the Accord, the System was really following the emergency principle.

It should be remembered this was the period when the System was limited in its use of open market operations. The rate was raised relatively early in terms of market rates to indicate the System's view as to the need for restraint.

- B. Since the Accord, the System has been following the principle of influencing availability.

Rate changes have lagged behind changes in market rates - at times considerably behind.

But changes in the rate have been made to reflect the System's judgment as to the degree of desirable restraint or ease.

This raises the question as to whether the volume of "free" reserves is an appropriate guide or whether attention should be directed to market rates as such.

(If you favor A or D - market rates not very important  
- except in A keep discount rate low enough and  
in D keep discount rate high enough)

(But B + C - pay more attention to market rates  
and conduct open market operations to control them!)