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PREPARING FOR THE FUTURE

By

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Federal Reserve Bank of Philadelphia

Before the

64th Annual Convention of the Pennsylvania Bankers Association
Wednesday morning, May 28, 1958, in Atlantic City, New Jersey

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I propose to discuss borrowing from the Federal Reserve Bank. I have selected this topic for discussion today precisely because few member banks have occasion to borrow at this time. The amount of borrowing is low in part because the Federal Reserve System has provided reserves liberally and cheaply in other ways as an important contribution to economic recovery.

Why, then, talk about such borrowing now? There are several reasons:

1. If experience is any guide, this will not be a permanent state of affairs.
2. We all wish to know the basic principles on which we operate.
3. We are more apt to establish valid principles when our immediate profit position is not affected by the decisions we reach.

Before I discuss borrowing as such I would like to describe briefly some of the economic developments and bank lending and investing policies that may lead to it.

The ebb and flow in the demand for loans at commercial banks is a reflection of the ebb and flow in economic activity itself. In periods of rising business and inflation, the demand for loans increases and the commercial banker wonders where to get the funds to lend, how to keep customers content with less money than they wish, and how to maintain good will while denying some applicants

altogether. In periods of declining business, on the other hand, the banker seeks customers who will borrow as well as other ways to employ idle funds.

These alterations in demand and supply would, of themselves, produce corresponding alterations in interest rates. Action of the monetary authorities who are pursuing a flexible policy adjusted to current conditions reinforces such changes in interest rates.

When demand for loans is slack a banker prefers to invest his excess funds in short-term securities so that the early maturities will provide the funds to meet his needs when loan demand again picks up. The same is true of bankers generally and of other lenders. As a consequence, short-term rates usually move down much more than long-term rates, and the structure of interest rates takes on an upward slope. This slope is confirmed when the market anticipates that rates will rise. The reason is that anyone who wishes to borrow or lend for a long period can do so either by means of a single contract for the entire term or by means of a series of short-term contracts. If the market anticipates a rise in rates, borrowers will prefer the long contract to beat the rise and lenders will prefer the short contracts so as to secure funds from maturities for reinvestment when the rise occurs. In other words, the supply of funds will concentrate in the short market and the demand for funds in the long market, thus confirming the upward slope in rates.

That is not the whole story, however. Slack loan demand and low rates of interest put pressure on bank earnings. There is, therefore, a strong temptation to meet the immediate problem of earnings by reaching out for longer maturities because of the relatively higher yields, even though prices are high. At such times it is not always recognized adequately that any investor assumes a risk when he buys the longer bond. It is the possibility that yields may go higher with a consequent loss of capital value. Even a relatively small change in yield will mean a relatively

large change in the market value of a long-term bond. Although an investor is more likely to remember this when the time for liquidation comes, it is more profitable to remember it when the initial investment decision is made.

The prices of long-term bonds, bought to secure income in a period of weak loan demand and easy money conditions, decline as money tightens. And, just when money tightens in response to economic expansion, the problem of the banker shifts from trying to find profitable outlets for excess funds to finding funds with which to meet expanding demands. The risk that was assumed when the long bonds were bought becomes a loss on the books. In seeking funds to meet expanding demands it is understandable that the banker might prefer not to sell the bonds because this would convert the book loss into an actual loss.

At this point hope often enters the picture - hope that the tightness will be only temporary. And, of course, experience shows that although the decline in prices continues as money tightens, eventually a peak in yields or a trough in bond prices is reached from which they move in the opposite directions.

Why not, therefore, tide over this period by borrowing? If the cost of borrowing is not too great, this might appear to be a method of having one's cake, the higher yield, and eating it too, not incurring a capital loss.

I want to indicate why member banks should not seek funds for this purpose from the Federal Reserve Bank. Suppose we look at the responsibilities of the Federal Reserve System under the conditions that have been described. It is the central bank which must adjust its monetary policy to economic developments. It tightens credit to restrain inflationary expansion. One evidence of tighter money is the higher interest rates that have been mentioned and the higher discount rates that the Reserve Banks themselves would charge under the circumstances. Another is a reduced availability of reserves.

The effectiveness of the System's efforts to restrain would be blunted if

reserves were made available freely, if member banks had no hesitancy in borrowing, and the Reserve Banks never asked any questions about continuous borrowing.

As an economist, I appreciate that the Reserve Banks probably could discourage, even to the point of preventing, such borrowing by charging a high enough rate. But that is not the kind of rate policy on which the Federal Reserve Act is based. The Act provides specifically:

"Each Federal Reserve Bank shall keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit ... or for any ... purpose inconsistent with the maintenance of sound credit conditions; and, in determining whether to grant or refuse advances, rediscounts or other credit accommodations, the Federal Reserve Bank shall give consideration to such information."

One reason for not relying on the rate exclusively is that the appropriate rate would have to be comparatively high. The same rate would have to be charged to all members; yet the primary purpose would be to discourage the relatively small number of banks that tend to borrow excessively. This is not to say that the discount rate is unimportant. On the contrary, it is an indispensable tool of monetary policy. Its level and changes in it influence the tone of the market, including market rates. I do not, however, have time to discuss it adequately today.

The discount window of the Federal Reserve Bank is like a safety valve that enables a member to secure funds temporarily to meet needs that could not reasonably be anticipated. It should not be necessary to charge a member that finds itself in such a condition the high rates that would be necessary to discourage the complacent borrower.

The principles and rules that govern loans to member banks are published as Regulation A of the Board of Governors. I would like to read from the foreword to that Regulation:

"Federal Reserve credit is generally extended on a short-term basis to a member bank in order to enable it to adjust its asset position when necessary because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those which can reasonably be met by use of the bank's own resources. Federal Reserve credit is also available for longer periods when necessary in order to assist member banks in meeting unusual situations, such as may result from national, regional, or local difficulties or from exceptional circumstances involving only particular member banks. Under ordinary conditions, the continuous use of Federal Reserve credit by a member bank over a considerable period of time is not regarded as appropriate.

"In considering a request for credit accommodation, each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally. It keeps informed of and takes into account the general character and amount of the loans and investments of the member bank. It considers whether the bank is borrowing principally for the purpose of obtaining a tax advantage or profiting from rate differentials and whether the bank is extending an undue amount of credit for the speculative carrying of or trading in securities, real estate, or commodities, or otherwise."

Borrowing at the Reserve Bank is significant to the member bank and to the Reserve Bank. To the member it is a privilege of obtaining additional reserves to meet unexpected needs. Ordinarily such needs would be for short periods though in exceptional cases they may be more extended. In any event, borrowing gives the bank time to make orderly adjustments in its assets should that become necessary. To the Reserve Bank appropriate borrowing has the advantages of supplying additional reserves directly to the banks that need them and of attaching a string to withdraw the reserves when the loan is repaid.

I would like now to try to clear up a few misunderstandings that I have heard about the administration of our discount policy. One of these is belief and repetition of an occasional rumor that I have heard phrased in these words: "Boy, the Fed sure is tough." It is difficult to trace such rumors to their source.

On occasion we have found that they begin with a banker whose borrowing record in terms of frequency, amount, and duration concerned us sufficiently to warrant a discussion. We do not, in these discussions, tell the banker how he should manage his own institution. We do point out that we have a responsibility to manage the Federal Reserve Bank in accordance with the law and that he should take into account that frequent or continuous borrowing is not appropriate except in unusual circumstances. I mention this because unfounded rumors may have kept some members from applying for advances for legitimate purposes. My suggestion is that when you hear such a rumor either ignore it altogether or investigate it until you have ascertained all relevant facts in the case. When the relevant facts are known, I would leave to your judgment whether we acted tough and capriciously or responsibly.

There has been some misunderstanding concerning the distinction I have drawn between managing our own Reserve Bank and managing the member bank. As a result, we have at times received unmerited praise and blame. Usually the praise is some variant of the following observation: "Thanks a lot for forcing me to sell those bonds to repay our debt to you. The bonds have since gone down several more points." The blame is some variant of these statements: "Your attitude cost my bank plenty. Those bonds you made me sell have since recovered several points." Actually, we do not tell a banker how to adjust his position so that he can repay. That is his problem. The nature of that problem will vary among banks, depending in part on earlier investment decisions. The results of action taken will also vary, depending on subsequent developments that cannot be foreseen.

Another misunderstanding is that the administration of discounting varies over time. I can appreciate how this misunderstanding arises. In a period of easy money most banks will be seeking ways to employ idle funds, relatively few will be borrowing at all, and very few, if any, may be borrowing

inappropriately. In a period of tight money, on the other hand, few banks will have idle funds, relatively more will be borrowing, and some may be complacent about their borrowing.

In other words the discount department of the Reserve Bank will usually be busier in a period of tight money than in a period of easy money. More banks may approach the continuous borrower category as sanguine expectations do not materialize. And so we have to make more telephone calls. This results, however, from maintenance of standards by the Reserve Bank and not from a change in standards or administration. An indication of uniformity of standards is the fact that occasionally we do find inappropriate borrowing even in recessions.

Now, every real craftsman in the field knows that credit cannot be administered according to mechanical rules. Among the important factors that are considered in evaluating the position of a particular bank are the following:

What is the nature and extent of its loan expansion?

Is it confronted with seasonal requirements for credit beyond those which could reasonably be anticipated?

To what extent has it liquidated other assets to meet the loan expansion?

Has it been subjected to unusual withdrawals of deposits?

Has the community in which the bank is located experienced economic adversity or other unusual developments that require time for solution or adjustment?

Officers of the Federal Reserve Bank are generally familiar with the managements and policies of most of the member banks in the District. Nevertheless, our discount officers find it desirable from time to time to supplement our knowledge by means of direct inquiry. Raising questions is at times a necessary part of proper administration of discounting. It is not the questions but the answers

that influence our judgment. You appreciate that I cannot cite specific cases but I know of instances in which the facts demonstrated that even extended borrowing was appropriate.

I move now to the reasoning that leads some observers to very different conclusions with respect to the investment policies of commercial banks, especially in recessions. Since many of the ingredients are the same as those I have mentioned, I can be brief.

Most analysts of business fluctuations would agree that lower long-term interest rates contribute to economic recovery from recession by stimulating construction of public works, of houses, and of plant and equipment. Since a rising demand for long-term bonds would tend to pull down long-term rates, some analysts would encourage all investors, including commercial banks, to purchase such bonds. A few observers, if I understand their reasoning, would even single out commercial banks particularly for such encouragement. They reason that such action by the commercial banks would contribute not only to the recovery but also to restraining later possible inflationary developments. It would help restrain inflation because the losses in capital values that accompany inflation would tend to freeze the bonds into the banks.

The logic behind this view has cogency. Nevertheless, I am not convinced that commercial banks should be encouraged to ignore their internal liquidity positions even in recessions. Their essential role differs from the role of those whose essential function is long-term investment. The genuine long-term investor can ride out a temporary loss in capital values. The commercial banker, on the other hand, is always faced with the possible demand for deposit withdrawal and with prospective demands from his borrowing customers. Particularly these latter demands - and for individual banks the former as well, as we have learned in the Third Federal Reserve District - are apt to come precisely when long-term bond

prices are depressed.

This does not disturb the analysts I have mentioned. On the contrary, they see it as a great advantage; because it would make a restrictive monetary policy more effective by putting greater pressure on banks. I have a hunch, however, that they are more expert at constructing economic models than at managing either commercial or central banks.

I have no desire to tell you how to run your institutions. That is your responsibility. On the other hand, I do have a responsibility with respect to the Federal Reserve Bank. In the nature of the case there is a reciprocal relationship between our operations. When you borrow from the Federal Reserve, the Federal Reserve lends to you. That is why it seemed appropriate to discuss Federal Reserve Bank lending policy at a time when loans are few and we can be most objective.

I cannot close without expressing what we all know and feel. We share a common goal of reasonably full use of our resources and a reasonably stable level of prices. The banking system alone cannot achieve this goal. Much else is needed in many areas. Nevertheless, appropriate monetary policy by the Federal Reserve System and appropriate policies of the commercial banks are indispensable parts of the common effort.

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