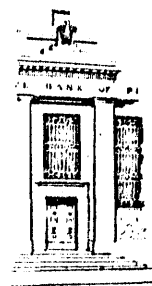


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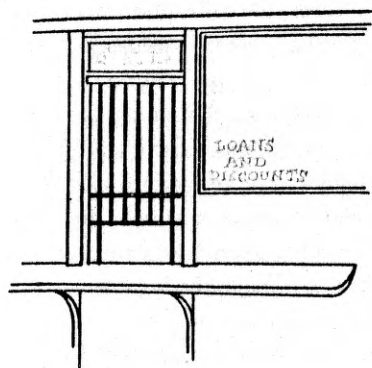
# DISCOUNT POLICY AND THE DISCOUNT RATE



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**FEDERAL RESERVE BANK OF PHILADELPHIA**





# DISCOUNT RATE AND THE DISCOUNT POLICY

In 1958, member-bank borrowing from the Reserve Banks declined as conditions in the money market became easier. Daily average borrowings reached a low of about \$100 million in July, and then rose as business activity improved and the money market tightened. There were five changes in the discount rate—three reductions in the first half and two increases in the latter part of the year.

Discount policy refers to the conditions governing discounting and borrowing from the Reserve Banks. It establishes the framework within which member banks may have access to Reserve Bank credit. The discount rate is a means of influencing the willingness of member banks to use the access to Reserve Bank credit afforded them by discount policy.

Both discount policy and the discount rate played prominent roles in the early history of the Federal Reserve System. Their importance waned in the thirties, however, as an inflow of gold and a weak demand for credit resulted in banks accumulating large excess reserves. During World War II and the early postwar period, the policy

of supporting the prices of Government securities, particularly the  $\frac{3}{8}$  per cent rate on Treasury bills, gave member banks ready access to Reserve Bank credit. Thus, for almost two decades, little use was made of the discount window.

The importance of discount policy and the discount rate re-emerged following termination in 1951 of the policy of supporting the prices of Government securities. Member banks turned to the discount window in increasing numbers to obtain funds to cover reserve deficiencies. The discount rate regained a position of importance as an instrument of monetary policy, although not the preeminence of earlier years.

The revival of interest in discount policy and the discount rate has stimulated questions as to their significance and as to their use. This article deals with three related questions: (1) Why do member banks sometimes borrow from the Reserve Bank? (2) When is borrowing from the Reserve Bank appropriate and when is it inappropriate? (3) What are the effects of a change in the discount rate?

## **WHY MEMBER BANKS NEED TO BORROW**

We all have the problem of keeping enough cash on hand or having ready access to cash sufficient to meet current payments. Sometimes cash receipts exceed, at other times fall short of expenses. To be in a position to meet expenses, therefore, we have to accumulate funds when receipts are larger than payments or borrow when our payments are larger than receipts.

Most individuals and business firms turn to commercial banks or to other financial institutions to balance out these short-run fluctuations in receipts and payments. The process of balancing short-run changes in receipts and expenditures thus tends to converge on commercial banks.

### **Factors affecting a bank's reserve position**

Commercial banks are required by law to maintain a reserve equivalent to a prescribed minimum percentage of their deposits. Member banks of the Federal Reserve System are required to hold this minimum reserve in the form of deposits in a Reserve Bank.

A great variety of transactions affects a member bank's reserve balance and the deposits against which the reserve is held. Many checks are deposited in banks other than the banks on which the checks are drawn. Banks send these checks drawn on other banks through regular clearing channels for payment. If a bank has an adverse clearing balance, it loses funds to other banks; if the balance is favorable, it gains funds from other banks. A corporate depositor may authorize its bank to transfer a large sum to a bank in another city where additional funds are needed to meet expenses. The transfer, made over the Federal Reserve's wire transfer facilities, results in an immediate reduction in the sending bank's reserve balance and a corresponding in-

crease in the reserve balance of the receiving bank. Business firms and other depositors withdraw cash to meet payrolls and other needs. United States Treasury receipts and expenditures, which nowadays are in large volume, constantly shift funds among banks. These are only a few of the many transactions that result in daily changes in a bank's reserve balance and the volume of its deposits against which the reserve is held. As a result, a bank's reserve position—whether in excess or below the legal requirement—is constantly changing.

Even though many factors affect a bank's reserve position, certain patterns of behavior are frequently discernible. First, most banks experience sudden irregular shifts of only one or a few days duration. A bank may have a reserve deficiency one day, an excess the next. It is extremely difficult to anticipate these day-to-day changes with reasonable accuracy. Second, seasonal trends frequently result in an inflow of funds in one season and a persistent drain on reserves in another. Banks in agricultural areas, for example, usually have a substantial inflow of funds during the crop-marketing season. They lose funds as farmers draw on their deposit balances for living expenses and the costs of producing next year's crop. In resort areas, banks gain funds during the vacation season and lose funds in the off-season. Third, a bank's reserve position may reflect longer-term trends arising from its own policies. If a bank is expanding its loans and investments more rapidly than other banks in its market area, it is likely to suffer a persistent loss of funds through clearings. Banks expanding less rapidly, on the other hand, tend to gain reserves. Finally, regional differences in the rate of economic expansion and growth cause some banks to gain deposits and reserves, others to lose them. Crop failure, floods, or some other form of disaster

may drastically curtail economic activity and put local banks under severe reserve pressure.

### Estimating the reserve position

Bankers have a profit incentive for keeping close tab on their reserve positions. A reserve balance in excess of the legal requirement earns no income; a deficiency incurs a penalty.

Certain features of the legal reserve requirement are especially important in managing a bank's reserve position. A member bank is not required to maintain a reserve balance equal to the specified percentages of its demand and time deposits *every* day. The requirement is in terms of *averages* over the computation period—of a bank's reserve balance each day and of daily totals of its demand and time deposits. (The reserve computation period is one week for member banks in central reserve and reserve cities, and semi-monthly for country member banks.) The reserve balance may drop below the required minimum for one or a few days, provided excess reserves on other days are sufficient to offset the deficits.

Another point is that certain deductions are allowed in computing the legal requirement against demand deposits. The two principal deductions are cash items in the process of collection and demand balances with other banks in the United States. The minimum percentage requirement is against net demand deposits, after deductions, not gross demand deposits.

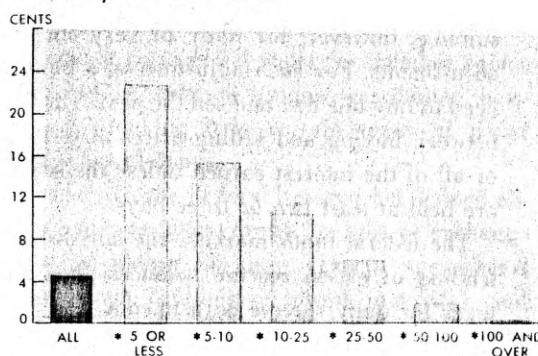
To facilitate estimating its reserve position, each member bank is supplied with a form with columns for entering total net demand deposits and total time deposits each day during the reserve computation period. The Reserve Bank sends each member bank a daily statement showing its actual reserve balance at the close of business that day. Most member banks receive this

statement the following day. By comparing the amount of reserve which would be required on the basis of net demand deposits and time deposits at the opening of business with the actual reserve balance at the close of business on the same day, a bank can determine with reasonable accuracy whether it is running a deficient or an excess reserve position.

Some member banks keep in closer touch with their reserve position than others. Large banks in financial centers watch their positions very closely to avoid having excess reserves that earn no income. They prepare estimates, as early in the morning as possible, of their reserve positions for the day. Most of them, on the basis of these estimates, make daily adjustments in their reserve positions, putting an excess into some income-producing asset or acquiring funds to cover a deficiency.

These large banks usually try to avoid having excess reserves. Their percentage of excess to required reserves is quite small. Smaller banks hold much larger percentages of excess to required reserves but the dollar amounts of their excesses are typically small. Small sums cannot be

NUMBER OF CENTS EXCESS PER DOLLAR OF REQUIRED RESERVES, BY SIZE GROUPS OF MEMBER BANKS, THIRD DISTRICT  
*First Half November 1958*



\*Deposits in Millions of Dollars

employed in the money market so easily and profitably as large amounts. It is not so convenient for many of the small banks located some distance from a money market to make daily adjustments in their reserve positions. For these and other reasons, officials of many small banks maintain a cushion of excess reserves to avoid a deficiency.

### **Alternative media for adjusting reserves**

Banks can use several methods to adjust their reserves. They can invest excess reserves in Treasury bills, commercial paper, or other securities; they can lend them temporarily to another bank or a securities dealer, or deposit them with a correspondent bank. To meet a reserve deficiency, a bank may liquidate securities, borrow the excess reserves of other banks, draw on its correspondent balance, or borrow from a Reserve Bank.

Bank preference is influenced by a number of factors. Treasury bills, other short-term securities, and commercial paper are commonly used as secondary reserves. Excess reserves so invested earn income and yet can readily be converted into cash with a minimum risk of capital loss when additional funds are needed. Short-term paper and securities are especially suitable for meeting seasonal and other longer-term reserve adjustments. Outright purchases and sales are not suitable, however, for daily or very short-term adjustments. For such adjustments, a bank may need to buy one day and sell the next. The spread between buying and selling prices absorbs most or all of the interest earned unless the securities are held at least two or three days.

The federal funds market—the borrowing and lending of excess reserve balances—has advantages for daily reserve adjustments. The bulk of these transactions is for one day, and there is no spread between buying and selling prices and

no risk of price change as in the case of short-term securities. Although the mechanics vary widely, the essence of a federal funds transaction is that a bank short of reserves borrows the excess reserves of another bank, agreeing to pay a specified rate of interest.

Because of its advantages for very short-term adjustments, the federal funds market has become widely used by the larger banks in financial centers to make daily adjustments in their reserve positions. The daily volume of transactions ranges from about one-half billion to over a billion dollars. The typical unit of trading is \$1 million; however, transactions for smaller amounts are frequently made, especially in periods of tight money. Banks with only small excesses or deficiencies are thus handicapped in using the federal funds market.

Member banks can borrow from a Reserve Bank to meet temporary reserve deficiencies, using subsequent excesses to repay the indebtedness; however, the Reserve Bank is not a profitable outlet for excess funds because excess reserve balances earn no income.

Relative cost is a significant influence in choosing among these reserve adjustment media. Banks naturally prefer to obtain funds as cheaply as possible. Normally, they will not borrow federal funds if they can borrow from the Reserve Bank at a cheaper rate. This explains why the federal funds rate rarely rises above the discount rate. Other influences are the attitude of bank management toward borrowing and toward such factors as the convenience of the different methods.

### **DISCOUNT POLICY**

One of the functions of a central bank is to provide elasticity in a country's currency and credit to avoid seasonal and other temporary strains and stresses. This means supplying currency and re-

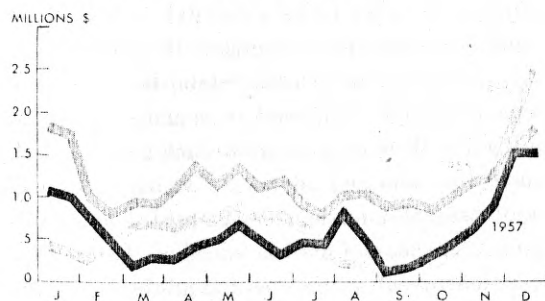
serves to meet the growing demands and absorbing currency and reserves during periods of seasonal slack.

Open-market operations are used to adjust the supply of reserves to the changing seasonal needs of the economy as a whole. For example, the Federal Reserve usually purchases Government securities in the latter part of the year to supply reserves absorbed by the outflow of currency into circulation and other seasonal factors; it reduces its holdings of Governments in the early part of the year to absorb some of the reserves created by the return flow of currency.

The discount window is more effective than open-market operations for meeting the seasonal reserve needs of particular banks or particular regions. Seasonal trends are not uniform for all banks. The peak needs of some banks may occur during a period of seasonal slack for the economy as a whole. Through the discount window, the Reserve Banks can supply reserves directly to the member banks which need them. Another advantage is that the reserves are supplied "with a string attached." Once the temporary need is over, the reserves are absorbed as member banks repay their indebtedness to the Reserve Banks.

Another important function of a central bank

**BORROWING FROM FEDERAL RESERVE BANK  
BY COUNTRY MEMBER BANKS IN  
AGRICULTURAL AREAS, THIRD DISTRICT**  
*Semi-Monthly Average of Daily Figures*



is that of regulating the supply, availability, and cost of reserves and credit in such a way as to help keep the price level stable and to help maintain economic stability at high levels of production and employment. To achieve these objectives, a central bank must have effective control over the volume of reserves it creates. This means that access to the discount window may have to be limited; otherwise, the amount of reserves created would be at the initiative of member banks, not the central bank. In practice, access to central-bank credit has usually been limited in two principal ways: (a) by establishing certain conditions under which banks can borrow, and (b) by changing the discount rate, making it more or less expensive for them to borrow.

### Historical development

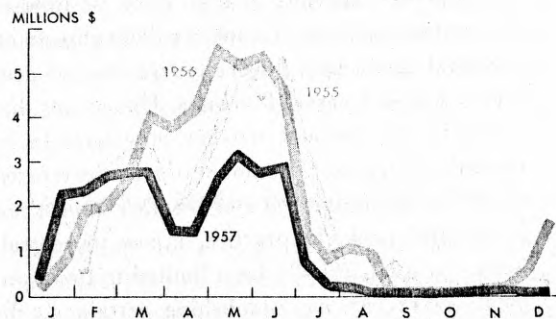
There has been a number of amendments to the provisions of the Federal Reserve Act relating to discounting and member-bank borrowing from the Reserve Bank; however, the principal developments in the philosophy of discount policy can be summarized briefly.

The dual nature of the discount function was recognized in the provisions of the Federal Reserve Act relating to the extension of credit to member banks. To provide the elasticity required in meeting seasonal and other temporary needs, the Federal Reserve Banks were given authority to discount commercial paper for member banks. Access to the discount window was limited, however, by making only certain types of paper eligible for discount.

Originally, the Federal Reserve Act defined eligible paper as notes, drafts, or bills of exchange maturing within 90 days (except agricultural paper which could have longer maturity) and drawn to provide funds for commercial, industrial, or agricultural purposes. Paper was ineli-

**BORROWING FROM FEDERAL RESERVE BANK  
BY COUNTRY MEMBER BANKS IN RESORT  
AREAS, THIRD DISTRICT**

*Semi-Monthly Average of Daily Figures*



gible for discount if the proceeds were to be used for speculative purposes, for fixed investment of any kind, or for the purpose of trading in securities except United States Government securities. In short, the philosophy of discount policy embodied in the Federal Reserve Act was that the Reserve Banks should extend credit to member banks only for short terms and for commercial, industrial, and agricultural purposes. It was also believed that by confining discounts to eligible paper, as defined, the quantity of Reserve Bank credit would adjust automatically to the varying needs of commercial and business activities.

Experience, especially in the thirties, revealed shortcomings in this early philosophy. Eligibility requirements proved ineffective in confining Reserve Bank credit to certain uses. Member banks discounted or borrowed against eligible paper to meet reserve deficiencies. The type of paper offered was no indication of the use made or to be made of the proceeds. Actually, discounts and advances supplied member banks with additional reserves. These reserves might be used for appropriate or inappropriate purposes.

A second difficulty was that eligibility requirements proved to be unduly restrictive at times.

The supply of eligible paper had been declining and was especially low during the crisis of the early thirties when deposit withdrawals were putting a heavy strain on the banks. The scarcity of eligible paper severely restricted the capacity of the Reserve Banks to issue Federal Reserve notes and to make discounts and advances to member banks. Finally, it became clear that eligibility requirements did not result automatically in a volume of reserves appropriate for maintaining stable prices and business stability at high levels of production and employment.

### **Current provisions**

Experience led to significant revisions in the Act which broadened member-bank access to Reserve Bank credit. Member banks may now obtain credit directly from a Reserve Bank for short periods by: (a) discounting eligible commercial paper maturing in 90 days (except for agricultural paper which may have a maturity up to nine months); (b) borrowing on their own notes secured by eligible paper or Government securities; or (c) borrowing on their own notes secured by any other assets satisfactory to the Reserve Bank but at a rate  $\frac{1}{2}$  per cent above the discount rate. As a matter of convenience, member banks obtain credit from the Reserve Banks almost entirely by borrowing on their own notes collateralized by Government securities.

The importance of administering the discount window in order to help maintain sound credit conditions was also recognized. Borrowing from a Reserve Bank was clearly established as a privilege, not a right. Section 4 as amended states that a Reserve Bank *may* extend to each member bank such discounts and advances "as may be safely and reasonably made with due regard for claims and demands of other member banks, the maintenance of sound credit conditions, and the



accommodation of commerce, industry, and agriculture."

Furthermore, each Reserve Bank is directed to keep informed as to the general character and amount of loans and investments of its member banks to determine whether undue use is being made of bank credit for speculative purposes or for any other purpose inconsistent with the maintenance of sound credit conditions. In determining whether to grant or refuse credit to a member bank, the Reserve Bank shall give consideration to such information.

Finally, a Reserve Bank is to administer the discount window, as well as its other affairs, "fairly and impartially and without discrimination in favor of or against any member bank." Authority was given to the Board of Governors to issue regulations further defining the conditions under which Reserve Bank credit is to be extended to member banks. The latest revision of Regulation A governing member-bank borrowing was made in 1955. The principal change was to put in a foreword to the regulation a statement of general principles governing Reserve Bank loans and discounts to member banks.

### **Appropriate borrowing**

Many member banks have been able to manage their asset and reserve positions without having to borrow from a Reserve Bank. Over one-half of the member banks in this district have not borrowed since 1950.

It is not possible to pinpoint every case in which it is appropriate or inappropriate for a member bank to borrow from the Reserve Bank. One of the lessons of experience is that the discount window cannot be properly administered by mechanical rules. The conditions and needs which give rise to borrowing vary. Each must be considered on its own merits. There are certain

general principles, however, that serve as guides in administering Reserve Bank loans and discounts which can be summarized briefly.

Even the most prudently managed bank may experience reserve drains for a few days which occasionally reduce its daily average reserve balance below the legal minimum. Borrowing from the Reserve Bank is one way of meeting these short-term reserve deficiencies. Should the deficiency prove to be for a more extended period, borrowing gives the bank time to make such adjustments in its assets as may be necessary.

Unusual seasonal requirements are another case of appropriate borrowing from a Reserve Bank. Seasonal needs can be pretty well anticipated and prepared for so long as they conform to past experience. But deposit losses may be exceptionally heavy, loan demands unusually strong, or both. Secondary reserves may not be sufficient to meet such unexpected seasonal requirements. Member banks may rightly turn to the discount window for additional funds.

There may be occasions when it is appropriate for a member bank to borrow for a more extended period. Sometimes local or national emergencies put severe pressure on banks' liquid resources. Considerable time may be required to make the necessary adjustments and work out a solution. It is recognized that in such infrequent and unusual situations, borrowing for an extended period may be appropriate in order that a bank may better meet community needs.

### **Inappropriate borrowing**

Many member banks borrow from a Reserve Bank only as a last resort. Few attempt to borrow for inappropriate purposes. Those instances usually arise from misunderstanding of the true function of the discount window. Final decision as to whether borrowing is inappropriate must take

into consideration the particular circumstances of the individual borrower. There are certain general types, however, which usually fall in the inappropriate category.

Borrowing to finance speculative activities—whether in securities, real estate, or commodities—is an inappropriate use of Reserve Bank credit. Paper drawn for such purposes has been ineligible for discount from the beginning of the System. Such use of Reserve Bank credit is undesirable from the standpoint of both the individual bank and monetary policy. Commercial bank officials have long frowned on loans to finance speculative activities. Experience has demonstrated that such loans are risky and all too frequently lead to financial difficulties. Even if safe for the individual lender, loans for purposes of speculation have a disruptive influence on the economy. Certainly, supplying member banks with reserves to support speculative loans is inconsistent with administering the discount window in such a way as to “maintain sound credit conditions” as provided in the Federal Reserve Act.

Borrowing to finance a member bank’s own investments is contrary to the spirit of the Federal Reserve Act. Investment is not a short-term, temporary need which bank management cannot reasonably anticipate. Borrowing to purchase securities for its own account is, in essence, an open-market operation conducted at the initiative of the member bank instead of the Federal Reserve System. Such borrowing, if widely practiced, would seriously impair Federal Reserve control over the supply of reserves and therefore its ability to regulate credit and the money supply in the interest of price and economic stability.

Similar in principle is borrowing from a Reserve Bank to avoid liquidating investments at a capital loss. Bank management in deciding to invest surplus funds in longer-term rather than

short maturities assumes the risk of incurring a larger capital loss should the securities have to be liquidated to meet expanding credit demands or other purposes. The inducement of a higher return on longer maturities should be weighed against the risk incurred. Extending credit to member banks to enable them to meet loan demands without liquidating investments is inconsistent with the Federal Reserve’s responsibility for “maintaining sound credit conditions.” This kind of discount policy would seriously weaken efforts to curb inflation during periods of strong credit demand.

Continuous borrowing, except in an emergency or some unusual situation, is also inconsistent with the principles embodied in the Federal Reserve Act. The purpose of the discount window is to make Reserve Bank credit directly available to member banks for temporary needs. Borrowing for a short period also gives a bank time to make such adjustments in its assets and lending policies as may be required in meeting longer-term requirements.

Borrowing from the Reserve Bank was never intended to be a source of capital to supplement a bank’s own resources. Even before the Federal Reserve System was formed, continuous borrowing from correspondent banks was frowned upon because experience had clearly demonstrated that a bank with a large debt was in a poor position to cope with hard times. Continuous borrowing, it should be noted, refers not only to consecutive days but also to consecutive reserve periods. A member bank borrowing \$7 million for one day increases its daily average reserve balance by the same amount as by borrowing \$1 million for seven days.

Borrowing to earn a rate differential or to gain a tax advantage are other purposes which are considered inappropriate.

## THE DISCOUNT RATE

Discount policy is designed to promote sound banking practices and to maintain sound credit conditions. It establishes the framework within which member banks have direct access to Reserve Bank credit. The principles followed in administering the discount window do not change from recession to boom.

The discount rate, however, is one of the principal tools used in combating inflationary and recessionary tendencies. There are three principal channels through which changes in the discount rate may influence the volume of reserves, the cost of credit, and the flow of total spending.

The direct effect is to raise or lower the price of admission to the discount window. An increase in the discount rate makes it more expensive and tends to discourage member-bank borrowing; a reduction tends to have the opposite effects.

The cost effect of a change in the discount rate cannot be isolated from other factors influencing the volume of member-bank borrowing. Obviously, an important influence is whether conditions are such that banks feel the need for additional funds. Given such needs, cost is a factor influencing their willingness to borrow from the Reserve Banks. As the discount rate is increased, the rising cost of borrowed reserves is an incentive for bankers to screen their loan applications more carefully to reduce the need for borrowing. The discount rate, if raised high enough, can be a strong deterrent to obtaining additional reserves by borrowing from the Reserve Banks. On the other hand, a reduction in the discount rate tends to increase the willingness of banks to borrow so long as they need additional reserves. The discount rate is an essential but not in itself an adequate tool for regulating the supply of member-bank reserves.

The policy of a penalty rate, long adhered to by the Bank of England, is based on the cost effect of the discount rate. The objective is to keep the discount rate above the rates received by the borrower on its own loans and investments so that the central bank will be used only as the lender of last resort. In England this means keeping the Bank rate (the discount rate) above market yields on Treasury bills and short-term paper, which account for the bulk of the assets of the discount houses. Commercial banks in need of funds call some of their loans to the discount houses, forcing them to borrow from the Bank of England. The discount rates of the Reserve Banks have rarely, if ever, been used as a penalty rate in this sense. To serve as a real penalty rate, the discount rate would have to be higher than the rates received by member banks on the bulk of their loans and investments.

A second and more important channel is the influence of the discount rate on the whole structure of market rates. There is a close interrelationship between the discount rate and short-term market rates because the Reserve Banks and the money market are alternative media for adjusting cash and reserve positions. If the discount rate is above market rates on Treasury bills and other short-term securities, there is an incentive for banks to liquidate short-term investments instead of borrowing from the Reserve Bank. Increased liquidation of short-term securities tends to push short-term rates up to the discount rate. If the discount rate is below market rates, it is cheaper for member banks to borrow from the Reserve Banks than to obtain funds by liquidating securities in the market. The availability of reserves at the discount window at a lower rate, by diminishing the sale of securities, tends to lower short-term rates. The discount rate has little influence on market rates when reserves are

so plentiful that member banks do not need to borrow.

Changes in the discount rate, mainly through the more direct effect on short-term rates and expectations (which will be discussed later) also influence intermediate and long-term rates. A rise in short-term rates, for example, makes short maturities more attractive relative to intermediate and longer maturities. As investment funds are diverted into shorter maturities, intermediate and long-term rates tend to rise. Thus a change in the discount rate tends to be reflected in the entire structure of market rates, although the effect on the rates of shorter maturities is more direct and usually more pronounced. A change in the discount rate sometimes induces banks to make a similar change in their rates on customer loans.

The effect on market rates is one of the more important channels through which discount-rate action affects spending. The impact is likely to be greater on borrowing for capital expenditures than borrowing for working capital purposes. When long-term rates are relatively high and the bond market is weak, borrowers are more reluctant to float new bond issues to finance capital expenditures. There is a tendency to defer new offerings pending a more favorable market. Rising long-term market rates, by making bonds more attractive relative to mortgages, also tend to reduce the flow of funds into mortgages. Declining long-term rates, on the other hand, tend to stimulate the flow of funds into capital expenditures and mortgages.

The effect on expectations is a third channel through which changes in the discount rate may influence spending and the volume of business activity. The public tends to interpret a change in the discount rate as a signal of Federal Reserve credit policy. The reduction in the discount rate in November 1957 was an excellent illustration.

Developing recessionary tendencies had created uncertainty as to the future of business and interest rates. The reduction in the discount rate seemed to remove all doubt that the future course of interest rates was downward. As a result, investors and speculators moved promptly to increase their holdings of Government securities and other fixed income obligations. The shift in expectations was an important reason for the sharp decline in market rates.

The effect on spending and the volume of business activity is not so clearly discernible. A reduction in the discount rate, by inducing expectations of easier money and lower interest rates, may also result in more favorable anticipations with respect to the volume of business and tend to bolster spending. It may be interpreted, however, as an indication that Federal Reserve officials anticipate slackening business activity and the initial effect on spending may be adverse. Public reaction to a change in the discount rate is often capricious. The effect on expectations, therefore, cannot be accurately anticipated.

The role of the discount rate is such that a change does not always represent a change in Federal Reserve credit policy. It may be only a technical adjustment to bring the discount rate closer into line with market rates as a means of maintaining the existing degree of restraint or ease. If as a result of open-market policy, reserve availability relative to credit demands has lifted market rates above the discount rate, an increase in the latter may be required to maintain the existing degree of restraint. Otherwise, member banks would seek relief from the higher rates by borrowing at the discount window, thus relieving some of the pressure on the market and market rates.

The close interrelationship between open-market operations and the discount rate is the

reason use of these two instruments is coordinated. In a period of expansion, when the objective is one of restraint, open-market operations may be directed toward supplying less reserves than are needed to meet expanding credit demands, thus forcing member banks to obtain additional reserves by borrowing. The reluctance of many banks to be in debt to the Reserve Bank causes them to screen their loan applications more carefully. For maximum effectiveness, however, the discount rate should be kept close to or above market rates. When the objective is easier credit, the effect of reducing the discount rate can be substantially augmented by supplying enough reserves through open-market operations to reduce substantially member-bank indebtedness to the Reserve Banks.

### IN CONCLUSION

The principles underlying current discount policy and use of the discount rate developed from many years of experience both here and abroad. The discount window was the primary source of reserves, and the discount rate the primary instrument of monetary policy in the early years of the Federal Reserve System. Although open-market operations have since become the principal instrument for regulating the total supply of reserves, the discount window and the discount rate continue to play significant roles in Federal Reserve policy.

Reserve Bank loans to member banks make a significant contribution toward smoothing out the day-to-day and month-to-month stresses and strains generated by a multitude of business and

financial transactions which are constantly shifting funds among banks. As a means of meeting temporary reserve needs, such loans have the advantages of channeling reserves directly to the banks which need them, and with a string attached. Once the need is over, member banks repay their indebtedness and the reserves are extinguished.

Unlimited access to the discount window would be inconsistent with maintaining sound credit conditions and an effective monetary policy. Discount policy is designed to afford member banks ready access to reserves for temporary and emergency needs but without impairing the ability of the Federal Reserve to regulate reserves and the money supply in order to help maintain sustainable economic growth without inflation or deflation. If it were not for discount policy, the discount rate would probably have to be raised higher — perhaps much higher — in periods of strong credit demand to restrict sufficiently the availability of reserves to prevent excessive credit expansion. The result might well be a severe penalty on member banks needing to borrow to cover short-term deficiencies which could not reasonably be anticipated.

The discount rate, although not the preeminent tool of the early years of the Federal Reserve System, is an important instrument of monetary policy. Directly, it operates as a cost, influencing somewhat the willingness of member banks to borrow from the Reserve Banks. Indirectly, it affects the structure of market rates. Use of the discount rate and open-market operations are coordinated because each helps to make the other more effective.