

August 19, 1954.

TO Discount Rate Committee Subject: Volume of Borrowing vs.
FROM Mr. Riefler Profitability of Borrowing

To what extent do member banks resort more freely to borrowing at the Federal Reserve Banks as the level of rates in the money market in relation to the discount rate makes it more profitable to do so? This is a central question for discount rate policy. That some banks do borrow frankly for profit when market rates of interest rise above the borrowing rate is established by the administrative experience of the Federal Reserve Banks' discounting activities. They have had, on occasion, to admonish member banks where the practice was flagrant and to indicate their desire that outstanding discounts be repaid. That other member banks refrain from borrowing from the Reserve Banks even when market rates make such borrowing highly profitable is also demonstrated by the administrative experience of the Federal Reserve Banks. A large number of member banks never borrow at the Reserve Banks at all and a further number, who do borrow, are clearly apprehensive of indebtedness to the Reserve Banks and repay their borrowing quickly, irrespective of the profitability of maintaining that borrowing. The problem, therefore, is not one of establishing whether or not member banks ever borrow for profit or whether or not member banks are exclusively motivated by a desire to remain out of debt. The problem, rather, is to come to a judgment on which of these motivations has been preponderant under conditions such as prevailed in the 1920's and conditions prevailing since the accord.

I devoted a great deal of effort to an analysis of this problem in the 1920's and came to the considered conclusion at that time that a desire to avoid large or continuous indebtedness had been the preponderant motivation of member banks. To the extent this was true, market rates of interest tended to rise when the necessity for borrowing increased. Correspondingly, they tended to fall when the necessity for borrowing decreased. It was this relationship, furthermore, that made open market operations effective as an instrument of System policy. At the same time, the evidence seemed to indicate that profitability of borrowing, though not a preponderant factor as a motivating force, was sufficiently operative to moderate fluctuations in open market rates of interest, and to cause these rates, except in periods of extreme ease or extreme tightness, to form themselves around the discount rate. Under these conditions, changes in discount rates were extremely important as a means of establishing a general level around which market rates of interest fluctuated. They also acted as a sort of discipline that maintained an attitude among member banks where borrowing would be used for short adjustments but continuous or heavy borrowing was avoided.

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These conclusions were based both on the behaviour of market rates of interest, in that they showed in their movements a much closer correlation with the volume of borrowing than with fluctuations in discount rates, and also on an analysis of the basic reasons for changes in the volume of borrowing as revealed in the elements analysis of factors responsible for the demand for Reserve Bank credit. As a matter of fact, the elements analysis as a precise inclusive computation was worked out initially to see what light it could throw on this problem.

Karl Bopp, in his paper on the "Role of the Discount Rate", presented to the Conference of Presidents of the Federal Reserve Banks on June 21, 1954, has put forth certain fundamental modifications of these conclusions. While not denying directly the relationship of the elements analysis to fluctuations in member bank borrowing, he comes to the conclusion, nevertheless, that the volume of member bank borrowing has been more largely affected by the profitability of borrowing than my analysis would have shown, and that "Within (a) limit of perhaps several billion dollars the general level of borrowing is closely related to the spreads between the discount rate and market rates." The only concrete evidence adduced to support these conclusions is summarized in two charts, one covering the period 1919-1930, the other covering the period 1952-54. Both charts present data on fluctuations (1) in discount rates, (2) in rates in the most sensitive open market, and (3) in the volume of member bank borrowing. Both charts, also, contain a line showing the difference, positive or negative, between the discount rate at New York and the most sensitive open market rate. This line is used as a measure of the profitability or lack of profitability of borrowing at the Reserve Bank. There is a high degree of visual correlation between this line and changes in the volume of borrowing, and it is on the basis of this visual correlation that the conclusion is reached that "the general level of borrowing is closely related to the spreads between the discount rate and market rate. This is the experience of the 1920's; it was confirmed in 1952-53. Borrowing increases when the discount rate is relatively low and decreases when it is relatively high in the structure of rates." These chart relationships also furnish the evidence for the conclusion that "It would appear, therefore, that the (discount) rate is an effective means of regulating total volume of borrowing." The conclusions, therefore, rest on the thesis portrayed in the charts that the relationship between the profitability of borrowing and the volume of borrowing is a causal relationship in which changes in the profitability of borrowing are the predominant causal factor in the changes in the volume of member bank borrowing.

This is directly contrary to findings which I have set forth and I would like to raise sharp issue with them. I would challenge these conclusions on two grounds. First, as a matter of analysis, I do not believe that a situation in which member bank borrowing was motivated solely

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or primarily by profitability would lead to a situation where changes in the profitability of borrowing was reflected proportionately in changes in the volume of borrowing. I think the striking correlation shown on the chart between profitability of borrowing to lend in the most sensitive open market and the actual volume of borrowing proves conclusively the opposite, namely, that member banks were not primarily or preponderantly motivated by profitability of borrowing in most of the years shown on the chart, particularly "within a range of perhaps several billion dollars." If they had been so motivated, the striking month-to-month correlation shown on the charts would not exist.

It is very important to be clear about the kinds of causal relationships that can be deduced from statistical correlations. The history of statistical and economic analyses is well sprinkled with "spurious" and "reverse" causal findings. In the case in point, i.e., a comparison of fluctuations in market rates of interest with fluctuations in member bank borrowing and in discount rates, the correct relationships are as follows:

A. The more member bank borrowing is motivated by profit considerations and the less by a desire to avoid indebtedness, the more closely will fluctuations in market rates of interest correlate with the changes in the discount rate and the less closely will they fluctuate with changes in the volume of member bank borrowing.

B. The more member bank borrowing is responsive to the desire to avoid a situation of indebtedness, the more closely will fluctuations in market rates of interest correlate with fluctuations in member bank borrowing and the less closely will they fluctuate with changes in discount rates.

These are the principles from which the relevant charts must be read, both those I have presented and those presented in the paper "The Role of the Discount Rate". The reasoning leading to this conclusion is quite simple. If member banks, within a range of several billions of dollars, borrowed when (and because) it was profitable to do so and repaid their borrowing when (and because) it became unprofitable to do so, they would borrow and lend in the most sensitive open market as soon as the rate of return in that market rose to a sufficient level above the discount rate to make the transaction profitable after administrative costs. They would continue to borrow as long as that margin persisted and they would retire from that market and pay off their borrowing as soon as the excess reserves accruing to the market from that borrowing put sufficient competitive funds into the market to drop the most sensitive open market rate below the margin of profitability. The result would be that the most sensitive market rate would tend to rise to

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a certain margin above the discount rate and then tend to stabilize there as long as the factors in the elements analysis indicated a demand for borrowed funds at the Reserve Banks. A close month-to-month correlation would not be expected between fluctuations in profitability of borrowing and fluctuations in the volume of borrowing under these conditions.

The correctness of this conclusion is proved, in fact, by one of the very charts presented in the paper to prove the opposite. There is one year shown on the chart when there was no correlation between profitability and volume of borrowing. In fact, the relationship was strikingly inverse. I refer to the year 1920. At that time, profitability decreased sharply throughout the year while the volume of borrowing increased sharply. In 1919, also, the correlation was poor. We know from history that those were the years when, because of relationships built up to promote war financing, the commercial bank tradition against being in debt to the Reserve Banks was weakest. Those were the years in which commercial banks were most willing to borrow to make a profit. I would not for a moment contend that the whole or any large part of the striking increase in actual borrowing in 1919 and 1920 shown on the chart represented a response to this profit motive. We know from the elements analysis that this is not the case and that gold outflows and demands for currency account primarily for the increase in borrowing. I would contend, however, that a very small increment of profit-motive borrowing from the Reserve Banks is sufficient to reduce market rates of interest to a relatively small margin above the discount rate, and that when profitability as a motive for borrowing is present in appreciable degree a correlation between fluctuations in the profitability and fluctuations in the volume of borrowing becomes conceptionally impossible. Certainly such correlations could not exist if profit-motivated borrowing remotely approached ranges of one billion dollars, to say nothing of several billion dollars.

This leads to my second grounds for questioning the findings of this paper. I feel an analysis resting on a simple demonstration of a correlation between profitability of borrowing and the volume of borrowing is incomplete. We have also at our disposal, as a tool that will help in understanding these relationships, the elements analysis which permits us to "account" exactly for each dollar of member bank borrowing. We know in what proportions that dollar, if it was made available to the market through borrowing, served, for example, (1) to permit gold or currency to flow out, (2) to permit an increase in required or excess reserves, or in Treasury or foreign balances, etc., and (3) to replace a dollar withdrawn through open market operations. Similarly, a dollar of member bank borrowing repaid to the Federal Reserve Banks can be proportioned through the elements analysis to concurrent movements in gold, currency, reserves, excess reserves, Treasury and foreign balances, etc., and open market operations.

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The availability of this additional tool should help us to evaluate the line of causation between borrowing, the profitability of money rates in the money market and gold and currency movements, open market operations and other factors in the demand for borrowing. We have, as a starting point, the two charts presented in the paper "Role of the Discount Rate." These charts show a fairly close relationship between fluctuations in the volume of member bank borrowing and fluctuations in the difference, plus or minus, between the discount rate, i.e., the member bank borrowing rate, and the most sensitive rate in the open market.

In the chart covering the 1920's, where profitability is measured as the difference between the New York Bank's discount rate and the widely fluctuating call loan rate, the scale of the chart has been so drawn that a change of 1 per cent plus or minus in the margin between the call loan rate and the discount rate is related roughly to a comparable change of 100 million dollars in the volume of member bank borrowing. In the chart covering the years 1952-54, where profitability is measured as the difference between the New York Reserve Bank's discount rate and the more stable rate (as compared with the call loan rate in the 1920's) on Treasury bills, the scale of the chart has been so drawn that a change of 1 per cent plus or minus in the margin between the Treasury bill rate and the discount rate is related roughly to a comparable change of one billion dollars in member bank borrowing.

Now, we have here a demonstrated and consistent (except for 1919 and 1920) relationship, on the one hand, between the volume of borrowing and the profitability of borrowing, and, on the other hand, we have in the elements analysis a consistent and completely invariant relationship between changes in the volume of borrowing and changes in the other factors in the element analysis, i.e., open market operations, gold movements, currency movements, changes in the volume of required and excess reserves, etc. It follows as an algebraic necessity that, as shown below, we can combine these two relationships into one statement, and in the process cancel out the common term, i.e., changes in the volume of borrowing and thus relate directly, for purposes of causal analysis, changes in profitability of borrowing to changes in the factors for reserve funds other than member bank borrowing.

Let a = changes in member bank borrowing in any given period,

b = changes in the profitability of borrowing at the Reserve Banks in the same given period,

and c = the net sum of concurrent changes in factors in the demand for Reserve Bank credit other than changes in member bank borrowing.

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Now since $a = b$ (roughly) according to the charts presented in "Role of the Discount Rate",

and $a = c$ (by definition) since the elements analysis is carried through to a completely balanced accounting concept,

it follows that $b = c$, if the analysis presented in the paper is valid.

In my view, this logical and algebraic necessity affords the acid test of the thesis presented in "Role of the Discount Rate." It means that if a 1 per cent change in profitability of member bank borrowing in the 1920's, as defined by the chart, was directly related statistically to a 100 million dollar change in member bank borrowing, then the same 1 per cent change in such profitability was equally directly related to a 100 million dollar change in the factors in the elements analysis other than member bank borrowing. If, for example, all of these other factors in a given period had remained unchanged except the one factor, open market operations, then a change in that one factor in such a way as to add 100 million dollars to the open market portfolio would in the 1920's be directly related to the concurrent decrease in the profitability of borrowing of 1 per cent. Similarly in the period since the accord, it means that if an increase of 1 billion dollars in the open market portfolio was directly related statistically to the concurrent decrease of one billion dollars in member bank borrowing, then the same increase of one billion dollars in the open market portfolio was directly related to a decrease of 1 per cent in the profitability of borrowing. These relationships follow inexorably from the logic of the charts presented in "Role of the Discount Rate", from the scales used in those charts, and from the way in which the charts are cited to provide evidence for the conclusion that "Within (the) limit of perhaps several billion dollars, the general level of borrowing is closely related to the spreads between the discount rate and market rates. This is the experience of the 1920's; it was confirmed in 1952-53. Borrowing increases when the discount rate is relatively low, and decreases when it is relatively high in the structure of rates."

While the relationships portrayed on the chart are purely associative, that is, a relationship of correlation is shown between changes in profitability and changes in borrowing with (so far as the chart is concerned) no indication of causality, the quotation cited clearly indicates that in the author's view the causality runs from profitability to changes in the volume of borrowing, i.e., that member banks in the aggregate borrow more not only when but because it is profitable to do so and reduce their borrowing not only when but because it becomes unprofitable. No other logic would be consistent with the reference to several billion dollars as the frame within which the re-

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lationship was true or to the final conclusion that "It would appear, therefore, that the rate is an effective means of regulating total volume of borrowing."

If that logic is correct, namely, that changes in the profitability of borrowing have directly and preponderantly caused changes in the volume of borrowing both in the 1920's and in 1952-54, it follows, according to the arithmetic of the elements analysis, that an addition to the open market portfolio of \$100 in the 1920's that permitted member banks to reduce their borrowing by 100 million dollars would have been caused by a decrease of 1 per cent in the profitability of borrowing to lend on call loans, and that an increase in the open market portfolio in 1952-54 that permitted member banks to pay off a billion dollars of borrowing would have been caused by a decrease of 1 per cent in the profitability of borrowing by member banks to buy Treasury bills.

Now, changes in the open market portfolio are initiated by the Federal Reserve System, not by the market. There have been large purchases and sales of securities by the Federal Open Market Account during the years covered by the chart. The decisions to make those purchases and sales have been arrived at after full discussion in duly recorded minutes of the Federal Open Market Committee. I have not checked the minutes through but I doubt whether any purchases have ever been made because the profitability of borrowing had decreased or any sales had been made because the profitability of borrowing had increased. Strange things happened during the period of the pegs, but even these purchases and sales were not so motivated. In the years covered by the chart, which do not include the years of pegging, purchases and sales of Open Market Committee were predominantly motivated by a desire to decrease or increase the necessity to borrow at the Reserve Banks. In carrying out these decisions, the profitability of borrowing was inevitably affected. That is the direction in which the causation runs. It does not run in the other direction as is indicated by the use made of the charts in the paper. Profitability did not first decrease because of discount rate action or extraneous market conditions, member banks did not then pay off their discounts because profitability had decreased, and the Federal Open Market Committee did not subsequently meet and decide to buy securities to provide funds to member banks to pay off borrowing that had already been repaid. On the other hand, purchases and sales were made in the full knowledge that they would have noticeable effects upon (a) the volume of member bank borrowing, (b) the level of rates in the money market, and (c) on the margin between those rates and the discount rate.

This point can perhaps be made concrete by analyzing the figures and correlations shown on the chart presented in "Role of the Discount Rate" over the period April 1953 to June 1954. In April 1953, with a discount rate of 2 per cent, the average market yield on 90-day Treasury bills was 2.19 per cent, having a margin of profitability of .19 per cent. In

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June 1954, with a discount rate of 1-1/2 per cent, the average market yield on Treasury bills was .64 per cent, having a negative margin of profitability of .86. The shift in profitability between the two dates, therefore, was 1.05 per cent. Correspondingly, borrowings at the Reserve Banks in April 1953 average 1,184 millions of dollars, and in June 1954, 166 millions of dollars, a decrease of 1,018 millions of dollars. The question at issue is whether the decrease of 1.05 per cent in the profitability of borrowing caused member banks, as suggested by the paper, to pay off over 1 billion dollars since holding of Treasury bills on borrowed money was no longer profitable, or conversely, whether the decrease in profitability reflected huge accessions of reserve funds put into the money market by the Federal Reserve System, accessions which permitted member banks to pay off their borrowing and also had an effect on Treasury bill rates. The elements analysis shown in the table can supply a clue to the answer. The table shows that demands on the market

Changes in Member Bank Reserves
and Related Items
April 1953--June 1954

(millions of dollars)

Factors adding to funds in market		Factors absorbing funds from market	
1. Increase in F. R. holdings of U. S. securities outright	1,154	1. Decrease in F. R. dis- counts and advances	1,018
2. Decrease in member bank reserve balances	337	2. Decrease in gold stock	635
3. All other factors net	<u>236</u>	3. Increase in money in circulation	<u>74</u>
Total	1,727	Total	1,727

during the period as a whole were limited to a withdrawal of 635 millions of gold by foreign interests and an increase of 74 million in money in circulation. Against this, funds were supplied by aggressive purchases of U. S. securities in the open market by the Federal Open Market Account, amounting to 1,154 millions of dollars and by a huge cut in reserve requirements which permitted member banks to build up their excess reserves and still reduce their aggregate balances by 337 millions. The effect of all other factors was an additional supply to the market of 236 millions of dollars. It is exceedingly difficult, if not impossible, to envisage a line of reasoning by which a decrease in the profitability of borrowing

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caused member banks in this period to reduce their discounts by 1,018 millions of dollars. Yet the correlation over this period between the drop in profitability of borrowing and the drop in the volume of borrowing is one of the major and most striking correlations shown on the chart. It is not difficult at all, on the other hand, to go over the debates within the Federal Reserve Board and the Federal Open Market Committee and find the considerations which led them to reduce reserve requirements and purchase securities aggressively in the open market in full knowledge and expectation that their actions would supply member banks with funds to pay off their borrowing and that lower money rates in the market and a decline in the margin between those rates and the discount rate would ensue.

Conclusions

1. Historically, when the Federal Reserve System was not pegging the Government securities market, there has been a close relation between fluctuations in the volume of borrowing and fluctuations of money rates in the open market. This was true of the period 1921-1930 and has been true since the accord.
2. Since money rates in the open market have fluctuated over a wider range than discount rates, there has necessarily been a similar but less close relation between fluctuations in member bank borrowing and in the estimated profitability of borrowing as measured by the difference plus or minus between open market money rates and discount rates.
3. These relationships have been closest when member banks predominantly observed the tradition against continuous indebtedness and resorted to the discount privilege primarily for temporary accommodation pending other portfolio adjustments. The relationships have been loosest or nonexistent in those periods, such as 1919 and 1920, when an appreciable proportion of member banks have shown a disposition to resort freely to the discount window of the Reserve Banks either to make a profit or to defer or avoid other adjustments in their operations.
4. It is logically permissible to cite these relationships between fluctuations in the volume of borrowing and in open market money rates as valid statistical evidence of the predominant attitude of member banks toward the discount privilege. So long as that attitude is against borrowing for profit, it is also permissible to cite these relationships as evidence that factors which supply or absorb reserve funds, particularly factors representing instruments of Federal Reserve System policy, such as open market operations and changes in reserve requirements, can and do affect money rates in the money market roughly in proportion to their effect on the borrowing of member banks.

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5. It is not logically permissible to draw from these relationships the conclusion that within a limit of several billions of dollars the general level of member bank borrowing has been related in a causal sense (except in 1919-1920) to spreads between market levels of interest rates and discount rates. Before making any such deduction, with cause running from the profitability of borrowing to changes in the volume of borrowing, the latter changes would, at the least, first have to be corrected for funds put into or taken out of the market through open market operations or other factors outside the control of member banks. In other words, the day-to-day correlation to test the effect of profitability on borrowing or the volume of borrowing would probably have to be run in terms of excess reserves, or possibly, also, in terms of changes in required reserves. I feel that it would be extremely difficult to isolate valid correlations.

6. A close examination of the historical evidence suggests that some member bank borrowing is affected by profitability. When this has happened on a wide scale as in 1919-1920, the simple statistical correlation between volume of borrowing and profitability disappears. When it occurs on a smaller scale, the correlation, while it does not disappear, is weakened. In either case, historically, the volume so affected has never ranged over billions of dollars. The effective range is probably in the tens or 50 millions of dollars. Any amounts, even in the hundred million dollar range, would flood the open market with sufficient reserve funds to remove the element of profitability.

7. So long as member banks predominantly observe the tradition against large or continuous indebtedness, it will be difficult, if not impossible, to isolate statistically the influence of the discount rate on the volume of borrowing. That volume is determined primarily by factors not subject to control by the member banks. As noted above, such fluctuations in borrowing as result from changes in profitability are likely to be too small in relation to concurrent fluctuations caused by changes in float, open market operations, etc., to be isolated and detected.

8. These conclusions do not mean that the discount rate is unimportant, that it does not affect the willingness of member banks to borrow, or that it cannot affect the level of money rates in the market. Clearly, it can and does, but that importance and effectiveness is not measurable by a comparison of spreads between discount rates and rates in the market with the volume of borrowing. When Federal Reserve policy actions have established a situation where the market as a whole must come to the Federal Reserve to borrow funds in appreciable volume to maintain required reserves, open market rates will, of course, be above the discount rate, and if the discount rate is raised above the market rates, those market rates will have to rise further. This will happen because most banks will try to avoid borrowing to make even temporary adjustments at a penalty rate. The consequences of these attempts to avoid borrowing at a penalty rate will

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raise market rates to a point where the penalty disappears. American experience has shown that it is impossible to have a penalty discount rate when the market is under pressure.

9. Profitability of borrowing has a direct relation to the volume of borrowing in one very important sense, namely, that little or no borrowing will take place at a penalty rate. It is always possible, of course, to establish a rate that can formally be described as a penalty rate by keeping the market so supplied with excess reserves through open market operations that no borrowing is necessary. It is a very different proposition to attempt to establish a discount rate that appears formally as a penalty rate, i.e., a discount rate higher than the bill rate, under circumstances where the Federal Reserve System desires to bring pressure against overexpansion by requiring member banks to obtain reserve funds through the discount window. In this case, the fact that member banks will go to great lengths to adjust their reserve positions, as for example through sales of securities, rather than borrow at a penalty rate, will set in motion the forces that cause market rates of interest to rise to such a point above the discount rate that the penalty disappears and borrowing appears profitable. Since different banks have different degrees of profitability at which they will undertake to adjust their reserve positions through borrowing rather than by other means, rates in the money market must rise, when the factors in the elements analysis require that some banks borrow, to the point where the margin of profitability was sufficient to induce the marginal member bank to borrow enough funds from the Federal Reserve Bank to bring balance in the elements analysis. Understood in this sense, profitability is not really a cause of borrowing, it is rather a necessary condition that must be established by rising interest rates in the market to induce the volume of borrowing that is necessary to clear the market. Understood in this sense, also, it becomes clear why a penalty rate could not be established and maintained under conditions where reserve policy was actively directed at restraint.

10. Under certain rigid assumptions as to the distribution of the schedule of the willingness or aversion felt by member banks toward borrowing at different degrees of profitability, it might be theoretically possible to find a correlation similar to that shown on the charts between the volume of borrowing and the profitability of borrowing. It would have to differ from the relationships shown on the charts, however, in one respect, namely, the correlation between changes in the volume of borrowing and changes in profitability of borrowing would have to be closer rather than less close than the correlation between changes in the volume of borrowing and changes in rates in the open money market. The most important limiting assumption would be that no important number of member banks borrow freely because it was profitable to do so. If even a relatively small number of larger member banks borrowed freely on the appearance of a margin of profit between the bill rate and the discount rate, that margin would disappear. The correlation, moreover, would tend to be inverse, i.e., the

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larger the volume of borrowing the smaller the margin of profitability. Any correlation between money rates or the profitability of borrowing thus rests essentially on the desire of banks to avoid debt. Perhaps the essential statistical analysis will become more clear if it is stated as follows:

(a) If the desire of member banks to avoid indebtedness was so strong that they never borrowed under any circumstances, banks would have to adjust to deficiencies in reserves by credit contraction sufficient to balance the elements analysis mainly through reductions in required reserves, contraction of the currency or the inducement of a gold inflow. Under these circumstances, money rates in the open market would fluctuate over a very large range in response, say, to open market operations, a range much larger than any in the experience of the Federal Reserve System.

(b) Since member banks in general have desired to avoid continuous indebtedness but have borrowed for temporary periods pending other adjustments when the market was deficient in reserves, money rates in the open market have fluctuated with the volume of borrowing and have brought about a situation where borrowing appeared profitable when there was need for it. The ranges of fluctuation of money rates, however, have not been extreme. These developments account for the correlations we have actually observed between 1921 and 1931 and also in recent years.

(c) If any really appreciable volume of borrowing was motivated solely by its profitability, fluctuations in money rates in the open market would be very much smaller than they have been in Federal Reserve experience. They would be limited for all practical purposes to the range of fluctuation of the discount rate and in fact would closely approximate that rate. How close that approximation can be in the highly sensitive New York money market was proved by the behaviour of acceptance rates in the 1920's. Acceptances represented an asset which the member banks and the market could sell to the Reserve Banks to obtain reserve funds without showing indebtedness on their balance sheet. They were sold freely to the Reserve Banks, consequently, whenever it was profitable to do so. The result was not a statistical correlation between the volume of acceptances sold to the Reserve Banks and the margin between the market acceptance rate and the acceptance buying rate posted by the Reserve Banks but an almost exact and invariant correlation between rates on

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acceptances in the market and the buying rate on acceptances posted by the Reserve Banks. When there were any discrepancies, investigation would show, I think, that they reflected unwillingness of the Reserve Bank to buy all bills offered at the posted rate.

11. The charts corroborate the finding that for the years shown since 1921, the role of the discount rate predominantly was to police the tradition against unjustified reliance on the borrowing privilege. When the System desired to tighten the market, it customarily did so through sales from its open market portfolio or by failing to add to its portfolio when reserve funds were in demand. This threw the burden of obtaining funds on the member banks who were forced to borrow them at the discount window. The immediate effect was to tighten the market and also widen the spread between the discount rate and market rates of interest. When this spread had widened to the point where the potential profitability of borrowing threatened to break down the tradition against undue reliance on borrowing, the System usually raised discount rates. Market rates also rose in consequence, with the result that the spread as such was not greatly affected. The effect of the generally higher level of rates, however, engendered a conservative financial attitude and a decision on the part of most bankers to get their houses in order.

12. Changes in the discount rate can, of course, affect the volume of borrowing to the extent that they affect the demand for cash balances, either currency or deposits, or attract or repel funds to other financial centers (via gold movements). These are longer range effects. They would not be shown in a correlation analysis on a current basis. They can be analyzed, however, in accounting for the forces which cause changes in the elements analysis. If the world was functioning freely under the gold standard (not the gold exchange standard), it would be perfectly possible, theoretically, for changes in discount rates to affect decisively the profitability of borrowing and through these repercussions the volume of borrowing. Even so, however, the results of these effects could not be tested by the simple linear correlations used as proof in these charts.

December 20, 1954

Christmas Verse -- Allan Sproul

Short-term, long-term,
Nearest thing to money,
Treasury bills and arbitrage
And other things -- not funny?
Forget it all this Christmastime,
Dismiss it with a laugh,
Who knows but Scots and Dutchmen
May find a middle path.

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C O P Y

DEPARTMENT OF
HEALTH, EDUCATION, AND WELFARE

Office of
The Under Secretary

December 21, 1954

Dear Win:

Thank you very much for your letter of the thirteenth and for sending me your memorandum, "Proposal to Insure Shares of Credit Unions."

It was good of you to prepare the material, and I look forward with interest to reading it.

With best wishes,

Sincerely,

(Signed) Nelson

Nelson A. Rockefeller

Mr. Winfield W. Riefler
Assistant to the Chairman
Board of Governors of the
Federal Reserve System
Washington, D. C.

Original incoming letter sent to files 12/27/54.

December 13, 1954.

The Honorable Nelson A. Rockefeller,
Under Secretary,
Department of Health, Education, and Welfare,
Health, Education, and Welfare Building,
Washington 25, D. C.

Dear Nelson:

You asked me to prepare a memorandum expressing my apprehensions about the direction in which Federal credit unions are moving. I tried to put them down on the enclosed paper. You understand, of course, that this is completely personal.

Sincerely yours,

Winfield W. Riefler,
Assistant to the Chairman.

Enclosure.

WWR:cls

File and Date copies, together with copy of enclosure, sent to files 12/14/54.

December 13, 1954.

The Honorable Arthur F. Burns,
Chairman,
Council of Economic Advisers,
Executive Office Building,
Washington 25, D. C.

Dear Arthur:

When Nelson Rockefeller asked that I prepare a memorandum expressing my apprehensions with respect to the direction in which Federal credit unions were going, you asked that you receive a copy also. I have just sent the enclosed memorandum to Mr. Rockefeller. You understand, of course, that this is purely personal.

Very sincerely yours,

Winfield W. Riefler,
Assistant to the Chairman.

Enclosure.

WRR:cls

File and date copies, together with copy of enclosure, sent to files 12/14/54.

Proposal to Insure Shares of Credit Unions

Winfield W. Riefler

The Government of the United States puts its general credit at the disposal of the managers of an organization when it guarantees the paper which that organization issues to obtain funds for its operations. Such paper is no longer subject to risk. Its purchasers no longer need be concerned with what is being done with their money, the soundness, for example, of its loans. Their only concern is with the rate of return and the terms and conditions on which the paper can be liquidated.

Is this in any sense desirable for the members of a credit union? Doesn't this negate the fundamental idea back of a credit union?

Credit unions have one and only one unique feature to justify the law permitting their charter as a separate type of lending institution. That feature is their non-professional character. It was the contention of those idealists who sponsored the credit union law that the plight of poor but frugal families caught in the web of financial adversity, because of sickness, disaster, etc., could be alleviated if provision were made for the charter of credit unions. It was contended that lending did not have to be professionalized when the two parties to the transaction knew each other because of close personal association, such as arises naturally in a shop or neighborhood. It was claimed that simple people, so associated, could pool their funds for loans to each other when they were in need and

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thus eliminate the scope of operation of the loan shark. Such people, it was held, did not need skilled training in credit analyses, elaborate examination, or a highly professional set up, since shareholders would not entrust their savings to officers of a credit union who would lend them imprudently or foolishly, and these officers in turn would not lend these savings to the improvident. Clearly, no one of these incentives would apply with anything like the same force if savers could purchase shares in credit unions with the assurance that their shares were as safe as E bonds so far as safety of principal was concerned, and with the prospect that they might yield a return to the purchaser materially higher than E bonds.

The problem posed by the credit union today is not how to attract more funds into this particular type of institution but rather how to preserve its character as a small non-professionalized institution for mutual self-help among closely associated people, such as neighbors or co-workers. It is this attribute of credit unions that justifies (1) the law permitting their charter, (2) their tax exempt status, and (3) the free services in the way of office space, unpaid services, etc., which they frequently enjoy. Most existing credit unions are small and, so far as they can be judged by this factor alone, appear to be still non-professional. The story is different when the distribution of total assets of credit unions and of their expense statements are examined. Twenty per cent of the total income of Federally chartered credit unions goes for wage and salary expense. This compares with 29 per cent for banks which are completely

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professionalized. Already 111 Federally chartered credit unions have passed the million dollar line. A million dollar financial institution no longer merits the classification of non-professional. It needs skilled full-time management. Its lending officers must be versed in highly specialized small loan lending techniques and in professional methods for policing collections. It probably requires the same meticulous examination procedures and personnel bonding devices as other professional lending institutions of comparable size.

The credit union operates in the field of personal credit. As a professional lending institution, it can grow rapidly and go far in this field. Total consumer credit outstanding is around twenty billions of dollars. It is characterized by relatively high rates of interest. Credit unions, with free quarters, no taxation, and the availability of unpaid services can really go to town if they start competing for this business, most of which originates in that sector of the population where they find their members. There would be almost no limit to their potential growth if they had Federal guarantee of their shares and therefore could compete with E bonds for savings.

The pressing immediate problem is to preserve the essential characteristics of credit unions. If that is preserved, they can make a unique contribution in humanizing our society. This contribution is lost when they become a sort of "fringe benefit" of the personnel department of a corporation and devote themselves to such activities as financing the automobile purchases of its employees. That path leads to size, to professionalization, to repossession techniques,

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and to elaborate supervision and examination procedures. When the end of the path is reached, we will find ourselves with a number of large professional lending institutions, whose growth was fostered by tax exemption, Federal guarantee and subsidy. No matter how much we seek to safeguard such large professional institutions by more elaborate supervision and examination procedures, they will always, and inevitably, constitute elements of instability and potential danger to the smooth functioning of the economy because of concentration of risk. It is elemental that professionalised financial institutions practice as much diversification of risk as possible. This credit unions cannot do, since they are organized basically around a single shop. Their memberships and their borrowers all are subject to the same economic hazard of unemployment in that shop.

It is this fear of what may happen in a depression to a credit union that lies back of the proposal to insure their shares. Surely it is important that methods other than insurance be devised to protect against this fear.

December 13, 1954.

WR:cl

Tuesday

Dear Wih,

By a curious coincidence of thought - I did locate Hilton Head - just a few hours before your note with all the leaders.

IT looks like a lot of fun - so will soon be immersed at your suggestion - and will reappear full of such zealous enlightenment that I wonder if our super-Reason-Dixonites will at all be able to endure - or resist.

Thanks.

Sandra P.

August 15, 1956.

Dear Sandra:

If you are really interested, maybe the following will help you locate Hilton Head: Hilton Head, by Josephine Pinckney (illus. by Raffaello Busoni). Published 1941 by Farrar & Rinehart (at \$2.75). Also published by F. & R.'s Canadian affiliate, Oxford (Toronto), at \$3.25. 524 pages.

If you do anything with it, I imagine you will be the first teacher of history north of the Mason-Dixon Line that has.

Sincerely,

Winfield W. Riefler,
Assistant to the Chairman.

Mrs. Roger Pierce,
2836 Chesapeake Street, N. W.,
Washington, D. C.

WWR:cls