The Discount Mechanism in the United States

1. Introduction

In July 1968 the Federal Reserve Board released a broad-gauged study of the discount mechanism containing significant proposals for changes in existing arrangements for access to central bank credit at the initiative of member banks. The proposals contained in the *Reappraisal of the Federal Reserve Discount Mechanism, Report of a System Committee* (subsequently referred to as the *Report*) do not represent a radical departure from past practices. Rather, they are designed to reestablish the discount window in its traditional role as a temporary source of bank liquidity. They take into account changes in United States banking conditions which over the years have led to an atrophy of this oldest instrument of central banking. Since, to a large extent, this development grew out of changing bankers' attitudes, successful implementation of the proposals hinges on altering these attitudes.

The *Report* has been given wide publicity, and a systematic effort is being made by the Federal Reserve System to explain its objectives and mechanics to bankers throughout the country in order to obtain their comments and suggestions. The proposals contained in the *Report* will be reviewed in the light of these comments, together with those being solicited from other interested parties, before the new arrangements are formalized in the form of an internal Federal Reserve Board regulation. There might also be further hearings before a Congressional committee. The proposals are cast in such a way as to make their implementation possible on the basis of existing legislation.

The discount mechanism study represents one of the most ambitious efforts undertaken by the Federal Reserve System to explore ways for improving an important monetary tool at its

disposal in the light of past experience. This endeavor is, however, by no means unique. The Federal Reserve System, which only a few years ago celebrated its fiftieth anniversary, is still operating basically within the framework of the original legislation, framed in a significantly different economic and financial environment. The generally recognized objectives of the System to contribute to achieving the national goals of maximum employment, maximum growth, substantial price stability and equilibrium in international accounts are not specifically acknowledged in the Federal Reserve Act, in spite of the several amendments, made over the years, to the 1913 law.

Nevertheless, since the last major revision of the Act, undertaken (1933-35) in the wake of broad reforms in the fields of banking and finance necessitated by the Great Depression, the Federal Reserve System has been continuously alert to the need for sharpening the tools at its disposal and examining the need for obtaining additional means for influencing credit and banking conditions. At one time or another, every single important monetary tool has been subject to intensive studies within the System, through the medium of specifically constituted committees with staffs drawn from Federal Reserve Banks and the Board of Governors and representing various talents, views and interests within the System. Thus, there have been several studies of reserve requirements with the objective of making this important control tool more flexible, more powerful and more attuned to the changing needs. Only recently (in the summer of 1966) an innovation was introduced by differentiating reserve ratios for time deposits according to the size of total holdings of such deposits by individual banks. Proposals to replace the present system of reserve requirements, based essentially on member bank location (simplified in July 1962 by abolishing the central reserve city classification), by graduated or uniform reserve requirements have been under consideration for several years.

Similarly, open market operations, which came into existence almost by accident in the early 1920s, have been subject to intensive examination. The controversy around the "bills only" doctrine, which grew out of a report made by a committee appointed by the System, was, in effect, a continuous reappraisal of the best use of what had become the main tool of monetary management in the United States. Subsequent to the abandonment of the bills only doctrine, various refinements in open market operations were developed, including reverse repurchase agreements, repurchase agreements made at rates differing from the discount rate, and the use of "cash" (same day) as well as "regular" (following business day) deliveries. Two major studies of the Government securities market, conducted jointly with the Treasury Department, were undertaken in order to uncover possibilities for improving its functioning and performance.

The adequacy and actual use of the various tools of monetary policy and their coordination, as well as the general effectiveness of monetary policy, have also been the subject of intensive studies by Congressional committees. They led to the issuance of the important "Douglas Committee Report" of 1950 and the "Patman Commitee Report" of 1952, and related materials, such as answers to committee questionnaires, other submissions and transcripts of related Congressional hearings held have been published. Among studies conducted by prestigious private organizations, the inquiry of the Commission on Money and Credit attracted considerable attention and eventuated in the publication of a considerable number of underlying studies as well as of a comprehensive report by the Commission itself (1). The scope of the numerous studies undertaken in the 1950s and the 1960s by official groups, including those appointed by the President of the United States, by private groups, and by the Federal Reserve System itself has ranged from the entire financial system to individual tools of monetary controls.

2. Contrast with Other Industrial Countries

It might be useful, before discussing the scope and significance of the Discount Study and its recommendations, to review briefly the important differences between the role of the discount mechanism in the United States and in the other leading countries.

In the United States bank credit accounts for a smaller part of total credit extended to the various segments of the economy than in most industrial countries. The ability of the United States to avoid runaway inflation was one of the main factors in developing

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(1) *Money and Credit, Their Influence on Jobs, Prices and Growth*, 1961, in particular Chapter 3. For a review of some other studies, see RAYMOND J. SAULNIER, *Recent Studies of Our Financial System*, Indiana Business Paper No. 9, University of Indiana, 1964.

a strong system of financial institutions through which the bulk of the country's financial savings is channeled. These institutions compete with commercial banks as a source of credit for all sectors of the economy. Financial intermediaries other than commercial banks hold the bulk of the country's financial liabilities. They provide most of the mortgage credit and are an important source of long-term business borrowing. Even a considerable portion of short-term credit is provided to businesses through the medium of commercial paper, much of which is held by business firms and others rather than by commercial banks.

Another basic difference is the channel through which reserves for secular growth and for meeting cyclical and seasonal needs are provided. Since the Great Depression at least, enlargement of bank reserves has occurred through acquisition of United States Treasury securities through Federal Reserve System open market operations, rather than by monetizing private debt, and fluctuations in the gold stock have been, in fact, automatically offset in the same way.

In contrast to most foreign countries, American banks do not hold part of their liquid reserves abroad. However, in recent years, with the development of the Eurodollar market, large banks, and in particular those with branches in London and elsewhere in Europe, have begun to actively use funds available in that market to adjust their reserve positions (2). This wider use of Eurodollars, together with the growth of the market for large negotiable certificates of deposit have been important aspects of the greater reliance by commercial banks on the adjustment of reserve positions through the management of liabilities rather than assets which developed in the 1960s (3).

Another important difference is the peculiar banking organization of the United States in which national banks operate along with State-chartered banks and the structure of banking in each of the fifty States is regulated, in effect, by State law. Additional problems arise from the voluntary nature of membership in the

(2) See Fred H. Klopstock, *The Euro-Dollar Market: Some Unresolved Issues*, Princeton, New Jersey, 1968.

(3) See Dolores P. Lynn, *Reserve Adjustments in the Eight Major New York City Banks during 1966*, Board of Governors of the Federal Reserve System, 1968. Unless otherwise stated, all subsequent references are to studies prepared for the discount mechanism study and published by the Board of Governors.

Federal Reserve System for State banks, which hold about two fifths of total deposits in the United States. Indeed, even after the conversion of the country's second largest bank to national status, only two among the New York City money market banks are national banks, while the remaining institutions operate under a State charter. Withdrawals from membership, usually by small State banks, in some parts of the country have become a more frequent occurrence in recent years. One consideration in reviewing the functioning of the discount mechanism was the desire to make membership in the Federal Reserve System more attractive.

In spite of the significant trend toward mergers in recent years, our fragmented banking system involves reserve management problems unique among industrial countries. Unit banking still dominates in the United States; of the 13,700 separate commercial banks now in operation, about 10,000 have not a single branch. Branch banking systems are limited to only a few States (and in some cases are permitted to operate only within part of a State) so that seasonal and erratic influences on deposits and loans (and ultimately on reserve positions) are not offset by opposite developments in other parts of the territory in which a bank operates.

The period during which legal reserve requirements have to be satisfied is shorter than in any other country. Since September 1968, reserve positions of even the smaller, so-called, country banks, must be met on a weekly average basis, but the new carry-forward provisions for reserve surpluses (although limited to two per cent of reserves held) provide a small degree of flexibility. For the larger banks, the inter-bank market for central bank balances, known as the Federal funds market, together with the other money market transactions, is the main medium for short-term reserve adjustments. For the smaller banks, short-term borrowing from the larger banks, usually located in money centers, is a most important means of obtaining funds to meet deposit withdrawals, to accommodate customers and to adjust reserve positions. The two groups of banks largely, but not entirely, coincide with the two classes of member banks established for reserve purposes.

The existence of a broad and active impersonal inter-bank market for excess reserves greatly facilitates reserve adjustments for the larger banks. Availability of Treasury checks and other payments in Federal funds to a variety of participants (such as, for instance, agencies or branches of foreign banks) has gradually

widened this market which, in the main, involves sales of reserves on the books of the Federal Reserve Banks among banks. This market was in limbo during the long period of excess liquidity, which lasted for almost two decades, after the depression of the 1930s. It reasserted itself with the revival of monetary policy in the early 1950s. In the early 1960s, even country banks began to make excess balances, frequently of a very moderate size (as small as $50,000), available to their correspondent banks, and through them to other banks, on a day-to-day basis.

In recent years, city banks, and in particular money market banks, have become increasingly dependent on the Federal funds market (which developed in many regional money market centers, with surpluses sold in the New York market). The size of transactions in this market by the 46 larger banks reporting daily currently ranges between $5 and $6 billion a day, taking purchases and sales together. Borrowings of New York money market banks in this market have not infrequently amounted to 30 per cent of required reserves for this group as a whole, and maybe even higher for individual banks (with other additional sources of money market funds and Eurodollars also used). Availability of funds from country banks arises, in part, from their desire to keep excess funds readily available to meet day-to-day fluctuations in their loans and deposits. Users of such funds were quick to conclude that a more liberal discount policy, and an increased willingness of country banks to rely on central bank accommodations would tend to diminish supply of funds in the Federal funds market.

The correspondent banking system offers the smaller banks an alternative to borrowing from the central bank (4). This network of relationships and services developed before the creation of the Federal Reserve System and for half a century it functioned in part as a substitute for a central bank. It still involves holding of balances by a country bank (in addition to those held by nonmembers to satisfy reserve requirements) with usually several city banks which provide the basis for a wide range of services. The most important among them are collection of checks and non-cash items, participation in loans (both ways), investment advice, along with a variety of other services which, because of staff limitations,

(4) Nonmember banks are even more dependent on city banks; with them they hold reserves prescribed by the individual States, except for vault cash and unless part of such reserves can be held in specified securities.

inadequate knowledge, and in some cases remote location, country banks could not otherwise obtain or offer to their customers. City banks rely heavily on interbank balances obtained from country banks, and they are inclined to oppose any changes that, in their judgment, may interfere with the continuation of the present arrangements.

Changes in the economy and in credit practices have resulted, in particular since World War II, in a structure of assets in which customer notes that would meet requirements at the discount window as stipulated in the Federal Reserve Act have lost much of their earlier importance. With the growth of term loans to business, revolving credit to merchants, and consumer credit, and with investment in mortgages and municipal obligations rising with large inflows of time deposits, the volume of short-term customer notes that would meet eligibility requirements (patterned at a time when the real bills doctrine prevailed) has shrunken over the years in relation to total assets. As a result, since World War II, central bank credit has been extended almost exclusively in the form of advances collateralized by United States Government securities.

Indeed, the distinction between discounts and advances has no place in the contemporary American central banking practice. Originally, credit was provided by Federal Reserve Banks as in European countries, by rediscounting customer notes, and eligibility provisions were considered an important element in controlling the volume of Bank credit. Thus, prior to the Great Depression, between 40 and 80 per cent of total Federal Reserve credit was supplied by discounting customer paper or by making advances collateralized by it.

The revival of lending to member banks, after atrophying in the 1930s and 1940s, occurred in circumstances where banks held large amounts of Government debt. The use of such securities as collateral considerably simplified procedures for obtaining central bank credit, in particular when these securities were kept in the custody of a Reserve Bank. Thus, virtually no customer paper has been discounted since the early 1940s (5).

(5) When in the early 1960s the Federal Reserve Bank of New York, wishing primarily to be prepared for an emergency situation, wanted to reacquaint its staff with the technique of discounting eligible paper, there remained very few bank employees familiar with routine procedures. Member banks had to be persuaded to submit some eligible paper in order to give an opportunity for training Federal Reserve employees to evaluate and process customer notes.

Under these circumstances, it seemed clearly desirable to give up the traditional narrow definition of eligible paper. As early as 1963 the Federal Reserve Board requested appropriate legislation which would enable the Reserve Banks to accept as collateral any debt instrument considered acceptable by them from a credit point of view. Unfortunately, however, the Congress has not as yet completed action on such legislation and quite naturally recommendations along these lines have been incorporated in the new *Report*.

3. Objectives

The discount study was initiated not because of any urgent need to change existing arrangements. The range of tools available to the Federal Reserve System is perhaps broader, and the flexibility with which they can be used greater than in most other countries. In particular, open market operations have proven to be a most suitable, powerful and flexible tool for achieving overall goals of monetary policy and for cushioning the impact of balance-of-payments deficits and of recurrent Treasury financing operations.

Of course, various criticisms of the way in which the discount mechanism has been functioning can be found in the pages of academic journals and banking publications. But this can be said in regard to almost any aspect of central bank policy and operations. And while academic critics have been advocating a variety of changes, ranging from controlling access to central bank credit exclusively by a rate graduated upward, as a function of size and duration of borrowing, to abolishing the discount window altogether, those banks which developed a reluctance to use the window, or never learned how to use it, have been very successful in developing alternative adjustment mechanisms.

Since the current objectives of monetary policy are implemented by regulating the overall availability of reserves, the discount mechanism merely contributes to distributing, through the market process, overall pressure throughout the banking system. Even in periods of ease, when reserves are supplied generously to stimulate lending, there is usually a certain amount of borrowing at the window, since reserves supplied through open market operations do not necessarily reach rapidly those banks.

The basic reason for initiating the discount mechanism study was the widespread feeling that existing provisions, codified in 1954 in " Regulation A ", issued by the Board of Governors, were too restrictive. Administration of the discount window in the spirit of that regulation has resulted in recent years in a situation in which large banks have increasingly shifted their borrowing to the market and small banks have put their faith in the correspondent bank's willingness and ability to meet their sudden as well as regular needs.

The restrictive character of Regulation A is easily explained by the historical setting in which it was last revised. Reactivation of monetary policy following the " Accord " of March 1951 occurred at the time of the war in Korea. An excess profits tax was imposed to create new fiscal resources. Excess profits were defined in relation to a capital base which was defined in such a way as to encourage banks to borrow. As a result, in a period of easy money, within a very short time borrowings at the discount window (in the form of advances, as explained above) skyrocketed from practically zero to close to $2 billion. This by itself was reason enough for the Federal Reserve System to become concerned with the efficacy of window administration after 20 years of virtual inactivity during which, first, gold inflow as a result of tensions and uncertainty in Europe and, subsequently, war-generated liquidity practically obviated the need for member banks to seek central bank credit.

A committee of Federal Reserve officials, supported by a working group of System economists, was appointed to examine conditions under which a revival of activity at the discount window had occurred. It came up with proposals to restrict the discount mechanism to the role of a safety valve. The philosophy underlying the new arrangements at the discount window was spelled out in considerable detail in the now famous " preamble " to Regulation A, issued in 1954, which, in effect, represented a shift from the real bills to the " safety valve " theory of discounting. The new regulation went so far as even to exclude provision of credit for seasonal needs from the area of appropriate borrowing. Indeed, member banks were expected to make adequate provisions to meet seasonal requirements of their customers from their own resources, resorting to central bank credit only to meet unexpected seasonal needs. Administration of a discount window surrounded by a number of restrictive conditions, including those concerning the purpose of borrowing, required contacts between discount officers

and borrowing banks whenever these were judged to have overstayed their welcome at the window, or for other reasons related to the use of the discount privilege.

Under present conditions, the initial extension of credit is normally automatic and in most instances is initiated by a telephone call from the member bank. If the borrowing has been outstanding for some time, usually after having been renewed, administrative pressure, frequently referred to as " discipline ", takes, initially, the form of a request to the borrowing bank to indicate how it plans to reduce or repay the central bank credit. Subsequent contacts, perhaps with an increasing degree of insistency, may be required if the bank does not undertake the required balance sheet adjustments to conform to the spirit of the regulation. The Federal Reserve Banks do not apply penalty rates or other sanctions to frequent borrowers or for prolonged borrowing, but banks sometimes resent contacts made by discount officers to obtain additional information on the reasons preventing the bank from repaying its debt and to request corrective actions when the discount officer concludes that they are called for in the given case.

Since individual Reserve Banks set their own internal guidelines and procedures for administering Regulation A, it has been claimed by bankers as well as by academic economists that the administration of the basic rules was not uniform among the 36 separate discount windows operated by the Federal Reserve System (at 12 Reserve Banks and 24 branches). Such lack of uniformity is difficult to document, since circumstances under which each specific credit is extended, including the condition of the borrowing bank, are not strictly comparable with any other instance of lending by the same or another Reserve Bank, and the various investigations on this point are somewhat inconclusive. The fact, however, that this impression is widespread among banks was by itself a sufficient reason for looking for an alternative which would minimize the possibility of such criticism.

But there were broader and more fundamental reasons for trying to devise a system for extending central bank credit under clearly defined conditions and precisely stated objective standards which would reduce the need for administrative decisions and foster member bank reliance on the central bank to meet normal adjustment needs without fear of coming under " administrative " pressure to adjust their positions. The record of recent years clearly indicates

that the reluctance of member banks to be in debt has greatly diminished (with some banks even no longer reluctant to show borrowing on published balance sheets), but that member banks preferred to borrow from their correspondents or in the impersonal Federal funds market rather than from the central bank even though the cost might range upward to one per cent above the discount rate.

Indeed, in 1959, which was a year of vigorous economic activity in which bank credit expanded rapidly and borrowing from the Federal Reserve was at about the highest level since World War II, the daily average amount of member bank borrowing accounted for only one third of estimated borrowings by these banks from all sources. In that year, fewer than one out of every three member banks came even once to the discount window, although eight out of ten of the larger banks (those in the Reserve City category) availed themselves of this privilege during at least one reserve period. In subsequent years, the role played by the Reserve Banks in meeting day-to-day and seasonal adjustment needs of member banks declined even further. In 1967, a period of rapidly expanding bank credit, although stagnant industrial production, average amounts of total borrowing by member banks were 2½ times larger than eight years earlier. Amounts obtained at the discount window had, however, declined sharply, even in absolute terms, and accounted for not much more than 3 per cent of borrowings; for city banks, this percentage was only 2 per cent. Not many more than one of every six member banks obtained advances one or more times during that year, and one out of three of the larger banks dispensed completely with using central bank credit. In 1967, only 1.1 per cent of the average daily amount of required reserves was supplied through the discount window.

Access to the discount window has been always regarded as one of the main attractions of membership in the Federal Reserve System. It was therefore felt that reluctance to come to the window tended to diminish the value of membership in the System for State banks. An episode, which occurred after the Discount Study was started, served to focus on one of the reasons for member bank reluctance to use central bank discount facilities. Although over the years Federal Reserve authorities have quite consistently rejected the use of the discount window as a means for influencing the distribution of bank credit and, more generally, have been reluctant to use selective credit controls, except in war and other emergency situations

and unless specifically instructed by the Congress to do so, many banks have remained suspicious of possible central bank desire to influence the composition of their portfolios. When, at a time of exceptionally buoyant business conditions and strong demand pressures on credit markets, the Federal Reserve System issued on September 1, 1966 a letter to assure banks that reserves would be made available to meet seasonal credit demands, but at the same time asking the banks, in a quite general way, to reduce their lending to business, offering at the same time special facilities to banks confronted with special needs, many bankers and commentators pointed to this letter as evidence of the central bank's eagerness to influence bank lending decisions. The special facility offered remained almost unused, and it quickly became clear that the letter itself had reinforced misunderstandings about the attitude of the Federal Reserve System toward the use of the discount window by its members. The experience with the " September 1 letter " was obviously one of the elements which entered into the consideration in assessing past experience and the need for a redesigned discount window.

4. Scope and Organization of the Study

The Discount Study was directed by a Steering Committee comprising three Governors and four Presidents of the Reserve Banks, under the chairmanship of Governor George Mitchell. The actual work of developing the various studies and formulating the basic approach leading to the proposals contained in the *Report* was in the hands of a Secretariat, led by Robert C. Holland, Secretary of the Board of Governors and of the Federal Open Market Committee. The Secretariat consisted of senior officials of the individual Reserve Banks, including several with direct responsibility for discount operations, and of the Board of Governors; several of them had experience as directors of economic research in their banks, while others were concerned with legal matters. The Secretariat held numerous sessions and between them maintained a close working relationship.

In discharging its responsibilities, the Secretariat endeavored to develop new statistical material in order to better appraise the functioning of the present mechanism and to evaluate the possible quantification impact of the proposals which it was considering and of those which it ultimately submitted to the Steering Committee. It

also undertook to develop new information in areas in which necessary knowledge was inadequate, such as correspondent bank relationships, and to present comprehensive analytical descriptions of certain financial markets which are used, or can be used, by banks for adjusting reserve positions (6). A special effort was made to review actual experience, past and present, in central banks in other advanced countries (7) to identify techniques that might be incorporated into the redesigned discount window, and to assess the prospective merits of alternative views with regard to the role of the discount function. A particular effort was also made to take into account past criticism and proposals made by the academic economists. Those who had published articles about discounting or otherwise were known to be interested were asked to submit their views in writing. A seminar-type discussion was held with some of this group and a few were commissioned to develop their proposals into formal reports (8). Finally, the various problems that might arise from the adoption of some of the proposals were examined.

Various members of the Steering Committee as well as of the Secretariat placed different emphasis on the significance of the various problems and the possibilities and need for change. They did not necessarily agree on the probable effects of the proposed changes on bank reserve management patterns, open market operations, and other related issues. This was not so much due to differences in basic outlook or lack of adequate statistical data, but to the fact that the future of the discount mechanism will to a large extent depend on whether the basic borrowing privilege and a more flexible use of the discount rate and all the other aspects of new window design will induce banks to make greater use of central bank advances.

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(6) Among them, PARKER WILLIS, *A Study of the Market for Federal Funds* and *The Secondary Market for Negotiable Certificates of Deposit* (by the same author) have been published so far. The entire scope of research undertaken is summarized in BERNARD SHULL'S *Report on Research Undertaken in Connection with A System Study* in which references to other relevant research are also to be found.

(7) GEORGE GARVY, *The Discount Mechanism in Leading Industrial Countries*, Board of Governors of the Federal Reserve System, 1968.

(8) DAVID M. JONES, *A Review of Recent Academic Literature on the Discount Mechanism*; LESTER CHANDLER, ed., *The Federal Reserve Discount Mechanism and Discount Policies* (a collection of replies); PRISCILLA ORMSBY, *Summary of Issues Raised at the Academic Seminar on Discounting*, Board of Governors of the Federal Reserve System, 1968.

Recommendations

Basically, the recommendations of the *Report* aim at achieving a more liberal administration of the discount window. The Steering Committee's proposals do not question the basic principle that a member bank should not be permanently in debt to the central bank. They do not envisage a larger role for discounting as a source of bank reserves to support growth, although a higher average level of borrowing is envisaged and accepted as a result of the new window design proposed. Credit at the discount window is to remain a temporary source of funds to meet member banks' needs for funds over limited periods. Limitations placed on the size and, perhaps more importantly, on the duration of borrowing reaffirms the view of the System that accommodations at the window should merely facilitate orderly assets and/or liabilities adjustments by individual banks once it becomes clear that the unfavorable flows are the result of deposit losses and/or loan demands of a more than passing or erratic character. The only significant change is with regard to seasonal needs.

The recommendations of the Steering Committee are thus based on four main premises: that 1) a liberalization of access to the discount window is desirable insofar as it can be achieved without jeopardizing the effectiveness of overall monetary controls, 2) there is no need to change significantly the relative position of the various tools; in particular, primary reliance continues to be placed on open market operations for achieving overall strategic goals, as well as for short range adjustments, 3) discounting should not be used as a source of reserves for broadening the credit basis of a growing economy, and 4) central bank lending should not be used as a means of selective credit control or to favor specific economic or social objectives.

More specifically, the Steering Committee rejected the use of the window as a means of channeling funds into geographic areas where credit deficiencies are the result of particularly rapid growth of individual industries or increased credit needs of agriculture, mostly as a result of the enlargement of average farm size and the growth of "agrobusiness" (9). Neither should the redesigned discount window serve to compensate for inefficient use of bank resources resulting from State legislation barring branch banking or other types of greater concentration of banking resources. The Steering Committee has also ruled out the use of the discount window for countercyclical purposes, believing that standards which remain unchanged over time are more likely to change bankers' attitudes with regard to using facilities offered at the window.

(9) A separate committee was subsequently appointed to continue studies of the shiftability of bank assets and liabilities, regarded as perhaps the most promising avenue for meeting the needs of banks servicing credit deficit areas or sectors.

The *Report* recognizes that perhaps excessive reliance has been placed on the "filtering down" theory of providing reserves to a complex and growing economy with credit needs greatly varying in individual sectors of the vast territory of the United States. It concluded that there was some advantage in leaving greater initiative to banks for obtaining reserves at the point where the need arises, instead of assigning to member-bank borrowing primarily the role of a safety valve to permit individual banks to adjust to overall effects of monetary policy being implemented by open market operations.

The *Report* concluded that neither domestic nor foreign experience suggests that a discount mechanism based on unquestioned access to the window, controlled exclusively by rate, would be either desirable or workable in the United States. While placing greater reliance on rationing by price was favored by some, the Steering Committee concluded that no level of rates within an acceptable range could effectively control demand for central bank credit should banks be confronted with strong and insistent demands from large depositors. Actual experience during several periods of vigorous expansion since World War II strongly suggests that availability and not cost of credit was a decisive factor.

The challenge consisted of shifting to individual banks a greater part of the initiative for reserve adjustment and making access to central bank credit available on more liberal terms defined by objective criteria, well understood and unvariable over time. The practical problem confronting the Committee was to formulate a new set of rules at the window that would routinize the borrowing privilege within a range of possible maximum amount that would prevent an outflow of central bank credit through the window so large as to conflict with the achievement of the overall goals of monetary policy. The Steering Committee believes that this goal can be best achieved not merely by a more liberal administration of the existing provisions, but by stipulating four specific ways in

which central bank credit would be obtainable at the initiative of the borrowing bank.

The *Report* recommends that to facilitate day-to-day adjustments in reserve positions each member bank be granted a "*basic borrowing privilege*" on a virtually automatic — "no questions asked" — basis. Since a major objective of the reform is to place such borrowing on an objective and uniformly defined basis, this privilege needed to be defined in very specific terms. However, in contrast to credit lines or quotas used by some central banks, the amount specified would not constitute a maximum ceiling.

The establishment of a "basic borrowing privilege" represents an innovation, but it may be also regarded as merely the formalized part of the broader concept of adjustment credit whose second component, "*other adjustment credit*", is designed to make funds available on virtually the same basis as under the present conditions for meeting unusually large or protracted needs experienced by banks from time to time. Indeed, even a system of quotas of considerable complexity could not possibly meet the variety of situations which could arise at a member bank, given its specific deposit and loan structure. Over time, a variety of legitimate reasons for recourse to central bank credit may develop at individual member banks. Instead of trying to foresee all such reasons and to make allowances for them in the computation of the basic borrowing privilege, the Steering Committee has chosen to propose a system under which such needs could be met under a different heading ("other adjustment credit") but essentially on the same terms as those applying to the basic borrowing privilege. Obviously, the Reserve Bank will want to satisfy itself, usually on the basis of statistical and other information already at its disposal, that the need to borrow above the amounts or for longer periods than those available under the "privilege" arises under circumstances which insure that such borrowing will be of a temporary nature.

Open market operations are now used, and will continue to be used, to offset excessive member bank borrowing in some periods and rapid declines in such borrowing in others. Under the proposed arrangements, in most periods, including those in which monetary policy pursues essentially a neutral course, few operating problems are likely to arise in achieving such needed coordination. But, if, in a period when the System is aiming at a tightening of credit conditions, member banks avail themselves within a short time of the maximum amounts available under an automatic borrowing provision, the resulting large injections of credit at the initiative of the banks might require even larger offsetting open market operations to achieve the desired degree of tightness in aggregate reserve positions and bank credit availability. It was thus necessary to set an upper limit to potential aggregate borrowings from the Federal Reserve System on a "no questions asked" basis, without, however, instituting a rigid system that would disregard the wide variety of specific borrowing needs that are a natural result of the fragmentation of the American banking system. Such upper limit has to be high enough to provide meaningful assistance to an individual bank without being so large in the aggregate as to make possible central bank credit injections at the initiative of member banks too large to be folded into whatever marginal changes in total reserves would seem appropriate for, or at least consistent with current monetary policy objectives.

The dilemma of making minimum amounts available even to the smallest banks, while putting a reasonable limit on potential aggregate lending was resolved by skewing the borrowing privilege in favor of these banks. This decision is consistent with the Commitee's objective of making the discount window more attractive to the smaller banks which generally do not have adequate access to the money market. It is proposed to define the borrowing privilege in terms of a percentage of each bank's capital stock and surplus, with a progressively smaller percentage applying to successive tranches of capital. (Alternative indicators of relative bank size could have been chosen and it is quite possible that the proposed basis might be modified when revised Regulation A is written.) The Committee suggested that the percentage may be set between 20 and 40 per cent for the first one million dollars in capital funds as defined above, between 10 and 20 per cent for the next $9 million, and 10 per cent for capital and surplus in excess of $10 million. Thus, a bank with a capital and surplus in excess of $50 million could borrow between $690,000 and $980,000 for each day of the seven-day reserve period (depending on the precise percentages adopted within the ranges proposed), but it could obtain seven times that amount if it borrowed for one day only. It would be a reasonable expectation that for the large banks the main benefit of this scheme would be to be able to borrow the large amounts

for one or two days at the end of the weekly reserve settlement period.

It was considered desirable to limit the frequency of borrowing under the basic privilege and to rule out continuous use of central bank credit over prolonged periods which would be tantamount to a semi-permanent addition to loanable funds or an equivalent reduction in reserve requirements. The *Report* proposes to regulate access to Federal Reserve credit in a flexible way, allowing a member bank to obtain an advance provided it had not borrowed in more than half of all periods within a given number of (weekly) reserve periods immediately preceding the new request. It is suggested that the length of this sequence be fixed between 13 and 26 reserve periods. Should the upper limit be ultimately chosen, a bank would be able to obtain credit at the discount window if it had not come to it in more than 13 of these periods. These periods could be either scattered over the half-year span or consecutive.

Only banks found to be in an unsatisfactory overall condition or not complying with law or regulations (and notified to that effect) would not be granted the basic borrowing privilege. It is also intended to continue the present administrative rule that banks should avoid net sales of reserve funds during the weekly reserve periods in which they are seeking central bank credit, except when such sales occur as a result of miscalculation or unforeseen last-minute changes in reserve positions.

Another innovation is the "*seasonal borrowing privilege*" available to banks which have a demonstrable recurrent pattern of need for funds persisting for at least several weeks, but not exceeding nine months. Contrary to the present practice, banks would be required to meet from their own resources only a stipulated minimum (rather than the full) amount of their needs for funds arising from seasonal losses of deposits and increases in loan demands. This amount could be fixed at somewhere between 5 or 10 per cent of their total deposits (the final determination to be made in the light of comments received). Member banks would be able to obtain the remainder under a separate seasonal borrowing privilege, entirely independent of any borrowing under the two headings already discussed. It would be quite possible for a bank to supplement seasonal peak needs by borrowing under the two adjustment credit provisions, or even to meet all of their seasonal needs under them if, for instance, several successive distinct periods of seasonal strain require temporary enlargement of reserves. It is suggested that the precise amounts which a bank might be entitled to could be, whenever possible, determined, through consultation and review of the bank's historic seasonal experience, before the actual need arose.

The fourth heading under which central bank credit will be available is "*emergency credit*". This section of the *Report* merely spells out — to the extent possible, given the unpredictable nature of major emergencies — the way in which the Federal Reserve System would perform its function of lender of last resort under a variety of conceivable circumstances. Recommendations under this heading go beyond a mere reiteration of the traditional readiness of the central bank to prevent or mitigate a liquidity crisis arising from whatever cause, and in particular to keep a localized situation from developing into a general liquidity crisis. It recognizes that in extreme circumstances the central bank must act as the ultimate source of liquidity to the economy as a whole, and not to member banks only. Thus, the proposed emergency credit facilities would be available to other sectors of the economy — primarily to financial institutions other than member banks — in order to prevent developments likely to have a serious impact on the economy's financial structure and on public confidence. The provisions suggested are, in fact, an outgrowth of *ad hoc* arrangements made during the "credit crunch" of the summer of 1966. They proceed from the assumption that once institutions other than member banks have exhausted sources of credit available under existing arrangements from other sources, the Federal Reserve Banks would, in cooperation with the proper supervisory authorities, assist the troubled institutions. Normally such assistance would be extended through the intermediation of member banks ("conduit arrangement"), since the institutions in difficulty normally would not have in their portfolios adequate amounts of "eligible paper" or U.S. Government securities to collateralize the required central bank credits.

The *Report's* recommendations for defining the basic borrowing privilege and borrowing facilities for seasonal needs are in terms of ranges. The precise terms will be set in the light of reactions received from bankers and other interested parties. For instance, the limits for the basic borrowing privilege may be set initially on the conservative side, and various provisions may be liberalized subsequently in the light of actual experience.

Changes in financial markets, in the structure of bank assets and liabilities and in techniques of liquidity management have greatly changed the way in which the need for central bank credit arises and the feasibility and attractiveness of recourse to alternative sources of funds for temporary adjustments. Given the cumulative effect on the reserve base of Federal Reserve credit supplied through open market operations and prospective needs for enlarging monetary and credit resources to support the projected growth of the American economy, it is unlikely that the proposed liberalization of the discount mechanism will result in a significant change in the structure of the reserve base, even though the proposed changes are likely to lead to a higher average level of borrowing at the discount window. Since formalization will not lead to a loss in flexibility in dealing with the legitimate adjustment needs of individual banks, the amount of borrowing outstanding may at times rise to levels that might exceed by a considerable margin amounts available under the formalized part of adjustment and seasonal credit, on single days or over weekly reserve periods. However, given the proposed conditions for such credits, it is expected that this borrowing will be done by a rotating group of member banks, even though some of it will be for relatively longer periods under the seasonal borrowing privilege.

While the *Report* is not explicitly critical of the discount rate policy since the Accord, it envisages a more active and flexible use of the rate as an integral part of the proposed redesign. Granting of unquestioned access to even a limited amount of central bank credit under the basic borrowing privilege requires setting of the discount rate at a level that would be realistic in relation to market conditions and follow changes in such conditions more closely than in the years since the Accord. Such closer linkage is, indeed, necessary in order to avoid discontinuities in the cost of alternative means available to banks for achieving reserve adjustments. Past experience strongly suggests that without the support of a discount rate more closely attuned to market rates an undue burden might be placed on day-to-day window administration. Current credit conditions and market expectations, as well as Federal Reserve policy objectives will determine at any given time the precise relationship of the discount rate to relevant market rates. It is believed that such greater flexibility in discount rate policy, which would require more frequent rate changes (and also perhaps by smaller amounts in both directions) than in the recent past, is feasible within the existing

framework of decision-making in which the initiative for the rate changes rests with the directors of the Reserve Banks.

The *Report's* recommendations with regard to the use of the rates have aroused considerable interest, since there has been widespread criticism of the timing of discount rate changes. One question that is being asked is whether too frequent changes might not destroy the " signal effect " of rate changes which many consider as important under the proposed system as now.

Apart from situations approaching a liquidity crisis, whose occurrence and precise nature never can be fully anticipated in advance, the role of the discount mechanism, under the proposed arrangements, will not be much different from the one it played since the revival of monetary policy. In contrast to several leading industrial countries, the United States has not attempted to use the discount mechanism for achieving specific objectives of credit policy, such as the allocation of member bank credit among final users or to stimulate exports. The *Report* specifically rejects suggestions for using the discount mechanism to solve problems that, basically, involve socio-economic and political decisions. The level and pattern of central bank credit provided through advances at the discount window will continue to provide an important indicator of banking and credit conditions. Open market operations, undertaken at the initiative of the System, will, however, remain the principal means for influencing credit and monetary conditions, thus by themselves affecting borrowing needs of member banks.

George Garvy

New York