Federal Reserve System Discount Policy: an Appraisal

There was a time after World War I when discount policy was pretty much the whole of the American quest, such as it was, for economic stability. Today, of course, we look much more to fiscal policy. And where we do look to monetary policy, we think not so much of the discount operation as official open-market operations — largely because the growth of the public debt has enhanced so the power and subtlety of the latter (1). Nevertheless, discount policy has had a place in the post-Accord shape of things. As a matter of fact, not long after the Accord the Federal Reserve System adopted as one of its aims the restoration of the discount mechanism to something of its former position; and since then the discount rate has been used actively as a weapon of credit control.

This decision and the subsequent use made of the discount mechanism have provoked a good bit of comment, both favorable and unfavorable. And inevitably the basic question of the proper role of discount policy has been raised again. Nor is this an unimportant issue. The post-war period has been marked by a renewed interest and confidence in classical monetary techniques; and it is not likely that the share of responsibility for economic stabilization now borne by the monetary authorities will lessen appreciably in the near future. Thus, even the person who is somewhat skeptical of the ability of classical measures alone to carry this rather considerable load has every reason for wanting monetary policy to be as effective as possible. This is the motivation for the present examination of current discount policy. In what follows, then, some

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(1) The classical reference on the significance of the growth of the public debt is R. V. Roosa, "Interest Rates and the Central Bank", *Money, Trade and Economic Growth* (New York, 1951).

of the more interesting points of view represented in the contemporary discussions will be outlined. And beyond this an attempt will be made to resolve the fundamental issue: whether or not the current policy is the best possible.

I. An Outline of Current Discount Policy

Our first experience with discounting subsequent to the Accord was not an altogether happy one. Member-bank indebtedness increased sharply; borrowings averaged roughly $ 1.1 billions for the period July 1952 through May 1953, whereas over the previous twelve months they averaged only about $ 36 billion (2). Moreover, this expansion of System credit was characterized by a considerable confusion. Just as in the 1920's, bankers and officials alike were unsure about how a request for credit was to be treated. (Was access to the discount window a right of membership, or was it to be granted subject to conditions laid down by the System?) So surprising and disconcerting were these developments that Federal Reserve officials took the first opportunity — the second half of 1953, when, because of the oncoming recession, demands on the discount facilities fell off — to re-examine their discount policy (3). And presumably the strategy of the past several years reflects the conclusions reached in this reappraisal (4).

Two aspects of current discount policy warrant special emphasis here. The first is the relationship between the discount rate and market-determined rates; and the second is the role played by non-price eligibility (or rationing) criteria in the regulation of member-bank borrowing.

Certainly one of the more interesting appearances of the period of credit restraint just past — roughly, from January 1955

(2) The reason most often cited for this rise in indebtedness is the tax incentive provided by the excess-profits tax which was on the books until the end of 1953. But it must also be remembered that until shortly before mid-1952 banks were operating in a world of pegged interest rates, and so were perhaps paying only casual attention to their secondary reserve positions.

(3) That such a study was being undertaken was first announced by the Board of Governors in its *40th Annual Report* (which covers operations for the calendar year 1953).

(4) This of course is only a conjecture, for the results (as such) of this study were never made public. But the latest statement of the Board of Governors' position — its *44th Annual Report* — reads as if this is a correct surmise.

through August 1957 — is the frequency with which the monetary authority adjusted the discount rate. True, it was increased 1/4 percent to a level of 2 percent in January 1953; and with the return to easy money, it was reduced in two stages (February and April 1954) to a level of 1 1/2 percent. But compare these with subsequent movements. In April 1955 the first of six upward adjustments of 1/4 percent was made, and by August 1956 the discount rate stood at 3 percent. In August 1957 there followed still another increase, this time of 1/2 percent. Then, when economic conditions changed, four downward revisions were made, so that by April 1958 the official borrowing rate was again 1 3/4 percent. Finally, in October 1958 the trend was again reversed when the rate was increased to 2 percent; and in November 1958 a level of 2 1/2 percent was established (5).

This contrast in the administration of the discount rate between the last three or so years and the first years after the Accord indicates clearly a movement in the direction of a more aggressive rate policy — an increased willingness to vary the official borrowing rate so as to keep it above, or at least not far below, the Treasury bill rate (6). And undoubtedly this is the pattern of the future.

But however interesting and important this development may be, too much should not be made of it. The point is that the System has still not gone so far as to establish a true penalty borrowing rate. Even during 1955 and 1956, for example, the discount rate was on occasion below the Treasury bill rate, with the result that member-banks were presented with an opportunity to « borrow for profit » (7). And this is not the whole picture. The maintenance

(5) The rate pattern cited here is that of the Federal Reserve Bank of New York. It should perhaps be noted in passing that occasionally (*e.g.*, in April 1956, and August-September 1958) all twelve banks do not keep together on their discount rates. Within the present context, however, differences in the timing and magnitude of the rate changes are not important and consequently can be ignored.

(6) As the graph in the Appendix shows, changes in the bill rate were much more promptly and fully matched in the period after January 1955 than previously. Also, a rather striking confirmation of this trend to a more aggressive rate policy is to be found in the fact that in August and September 1957 several of the Reserve Banks raised their discount rates 1/4 percent, and at a time when the general economic outlook was far from clear.

(7) Since Treasury bills are now widely used by commercial banks to adjust their reserve positions, the relationship between the bill and discount rates is currently more important than that between the commercial paper and discount rates. Thus, if the bill rate exceeds the discount rate, member-banks will have an incentive to acquire borrowed reserves. And, when this spread is reversed, those with bills in their portfolios will prefer (out of profit considerations alone) to run down these holdings rather than go to the discount window.

of a penalty rate calls for more than simply keeping the official rate only slightly above the bill rate (which is the most that can be said for the Federal Reserve's policy). For one thing, banks with bills in their portfolios may nevertheless be willing to pay a modest premium for borrowed reserves in order to hold onto their money-market assets as a hedge against a tighter discount policy later on (8). Moreover, as the law governing discount operations now stands, Reserve Banks can make advances to a member-bank on the latter's own promissory note if the note is secured by marketable obligations of the federal government; and there is no restriction on the maturity of the pledged assets (9). Hence, a member-bank may well find itself in the position, when out of Treasury bills, of being able to borrow against collateral paying a return higher than the rate charged by its Reserve Bank.

Now, obviously, these remarks are not meant to suggest that member-banks seize every opportunity to borrow for profit. Whether or not they do depends, among other things, on how they feel about being in debt to the System; and this, as will be seen presently, is a point of considerable controversy. For the moment, however, it is enough to recognize that banks holding few or no bills — which perhaps is not an unusual situation when a policy of credit restraint has been in force for a while — are typically in a position to borrow for profit; and even banks holding bills are on occasion also in a position to do so.

That the discount rate is not now a penalty rate in the sense of, say, the British Bank Rate is hardly cause for surprise. It never has been. Nor has there ever, except perhaps towards the end of World War I, been much feeling for taking the big step (10). Often it is suggested that a penalty rate, while no doubt well suited to British institutional arrangements, is an administrative impossibility in the United States (11). There seems, however, to be little

(8) The assumption is that System credits need not be rationed by price alone.

(9) For a complete statement of the rules governing Federal Reserve discount operations, see Regulation A (Revised) of the Board of Governors of the Federal Reserve System: Advances and Discounts by Federal Reserve Banks.

(10) On this and the other historical points made here, see S. E. Harris, *Twenty Years of Federal Reserve Policy* (Cambridge, 1939), Part I; see also L. V. Chandler, *Benjamin Strong* (Washington, 1958).

(11) See, for example, W. L. Smith, "The Discount Rate as a Credit-Control Weapon", *Journal of Political Economy*, April 1958, p. 171n. "In the United States", Smith writes,

substance to this argument (12). Indeed, it would appear more probable that the explanation for the resistance to the idea of a penalty rate lies more in political or policy, rather than technical, considerations. In the early days of the System, regional bank officials in particular were dominated by a commercial banker's mentality, and so tended to think of showing a profit on their operations and of competitive, not penalty, borrowing rates. They also conceived of their banks as primarily serving the banking community rather than the public good. All along, as a matter of fact, although the other nonsense has been pretty much put aside, the monetary authorities have continued to show themselves sensitive to the « needs of commerce, industry and agriculture ». And instead of a penalty rate, there developed the idea that commercial bankers are reluctant to be in debt to the System — that while they might borrow to cover a sudden loss of deposits, they would never borrow for a profit.

Now there certainly would seem to be an element of convenience in this view; but right or wrong, it has served for a long time as a justification for not instituting a penalty discount rate. Only recently have System spokesmen backed off even slightly from the extreme position held during the years before World War II. This, one gathers, is what lies behind the revision of Regulation A — covering discounts and advances by Reserve Banks — which was announced in 1955 (13). The revision was apparently intended to make unmistakably clear that the System regards access to its discount facilities as a privilege, not a right; or put differently, it emphasized the fact that more than ability to pay could be required of member-banks wanting borrowed reserves. Thus, an application for discount credit might be turned down by a Reserve Bank because the applying bank wants to borrow for the « wrong » reason, or

"a penalty rate is impracticable because there are several thousand member banks able to borrow directly from the Federal Reserve and invest their funds in a broad range of assets carrying widely varying interest rates".

(12) Why is it not possible to approximate the intent of the British Bank Rate *qua* penalty rate by simply setting up a formula which takes into account the situation of the particular bank applying for borrowed reserves? Thus, for example, if the bank in question holds Treasury certificates but no bills, and if the certificate rate is above the bill rate, then it should be made to pay a rate on borrowed reserves in excess, not just of the bill rate, but also the certificate rate.

(13) The most important part of this Regulation, the introduction or statement of General Principles, can be found in the January 1955 issue of the *Federal Reserve Bulletin*.

because the bank in question has borrowed too frequently in the past, or because the condition of its loan and investment portfolio is not all that the authorities would like. In any event, the publicity given these non-price eligibility conditions can be intepreted as evidence of a waning faith in the supposed traditional reluctance of member-banks to be in debt to the Federal Reserve.

It is clear then that, potentially at least, discount policy has two distinct aspects; it may involve price and non-price rationing (14). And it is also clear that the non-penalty character of the discount rate need not be significant. That is, if the authorities so choose, they can regulate the level of member-bank indebtedness without reference to the discount rate. Where the supposed traditional reluctance of member-banks weakens in the face of increasingly profitable opportunities, non-price eligibility conditions can (conceivably) be put in the way of the unwanted expansion of System credit.

II. The Official View on Discount Policy

Looking at the record of member-bank borrowing, one is struck with the apparent perversity of discount policy (15). Moreover, there is a sense in which this perversity is perhaps other than appearance. But as Federal Reserve theoreticians would quickly point out, critics of present-day discount policy who argue simply from the fact that average indebtedness increases in periods of credit restraint and decreases in periods of credit ease are largely wide of the mark. They forget that the System has another arm, its Open-Market Committee, which can be used to counter-balance changes in the level of member-bank borrowing. And they forget, or refuse to acknowledge, another tenet of the official doctrine: that borrowed reserves are not truly an offset to reserves lost through, say, open-market operations because by choice they are only a very temporary stop-gap. According to the so-called « need » theory of discounting, member-banks may borrow when faced with a sudden loss of deposits or, when already fully loaned up, with

(14 The word "potentially" should be emphasized, for, as will be clear from what follows, the System does not make much use of its non-price eligibility conditions.

(15) A quarterly time-series of member-bank average indebtedness is given in the Appendix.

a loan request from a customer of long-standing; yet they will never turn to the discount window just to exploit a profitable differential between the lending and borrowing rates confronting them. Furthermore, their (supposed) reluctance to go into debt to the System will push them to reduce their borrowings as soon as is humanly possible. Thus, not only is it wrong in the official view to look at the level of borrowed reserves without paying attention to open-market activities, it is also wrong to think that the reserve position of member-banks (and hence the over-all credit situation) is unaffected by the ratio of borrowed to required reserves (16). The discount window may serve to ease the shock of official open-market activities, but it is not therefore a means of permanent escape.

The other important aspect of the monetary authorities' version of discount policy concerns the impact of changes in the discount rate on the expectations of the private sector of the economy. Interestingly enough, this « announcement effect » as it is sometimes called is presented as an asymmetrical influence on behavior. Lenders — in particular, commercial banks — are held to interpret an increase in the System's borrowing rate as a sure sign that tighter credit conditions lie just ahead, and are thus prompted to adopt a more conservative lending policy before such a course is actually forced upon them. Borrowers on the other hand are alleged to take the increase a signalling the end of good times, and as a result move to cut back their spending plans and pare down their loan demands. From both sides of the market, then, the responses are apparently stabilizing (17).

III. Alternatives to Current Policy: Rationale and Strategy

The foregoing interpretation of discount policy, though stoutly defended by Federal Reserve spokesmen, does not appear snug and sound to everyone. Recently in fact — perhaps as a corollary to the greater emphasis being put on discount operations — it

(16) It is this view which motivates the use of the concept "free reserves" (excess reserves minus borrowed reserves) as an index of credit conditions. See "The Significance and Limitations of Free Reserves", *Monthly Review* of the Federal Reserve Bank of New York, November 1958, pp. 162-7.

(17) A reduction in the discount rate is supposedly productive of exactly opposite responses.

has been seriously questioned. It is to these criticisms, and the implied modifications of current policy, that we now turn.

A. *The Need for Discount Facilities*: Implicit in the "need" theory of rediscounting is the assumption that the discount windows of the regional Reserve Banks are in some sense essential features of our institutional arrangements. For this reason, the claim that member-bank borrowings are not a permanent offset to other System activities is entirely too negative a way of defending the discount operation. It is perhaps more accurate to characterize the official position as arguing that the combination of discount and open-market operations is actually superior to the latter alone. This stronger statement hinges on the legitimacy of the "safety-valve" interpretation of the discount window, for which, in turn, there are a number of possible defenses (18).

The rules governing reserve balances which were imposed under the Federal Reserve Act are quite strict; the averaging period used in computing required reserves is short, and the penalty for failing to maintain adequate reserves is certainly not inconsequential (19). Thus, member-banks — working within a rigid fractional reserve framework, and dealing with volatile, unpredictable liabilities and loan demands — are faced with something of a problem (20). It is this problem which has given rise to the claim that a discount mechanism *qua* safety-valve is essential, and to defenses of this claim which involve considerations both of equity and of economic efficiency.

Imposing reserve requirements sets a limit on bank earnings. Moreover, when these requirements are rigidly applied, the matter does not end with this direct influence. Considering the alternatives

(18) It is clear that this argument — which proceeds by establishing the need for discount facilities — is not by itself a strong defense of any particular discount policy. At the same time, though, it is also clear that the validity of the argument has a direct bearing on the problem of selecting the "best" discount policy.

(19) For banks located in cities having either a Reserve Bank or a Reserve Bank branch, required reserves are computed by taking a weekly average of deposit liabilities; a two week averaging period is used for all other banks. Member-banks are charged a rate equal to the current discount rate plus two percent on the cumulative reserve deficiency shown for the given computation period.

(20) The individual members of a unit banking system are especially vulnerable to deposit losses. For an analysis of the causes and significance of this, see E. C. SIMMONS, "The Monetary Mechanism Since the War", *Journal of Political Economy*, April 1950.

available to a member-bank faced with a reserve deficiency, it becomes apparent that they are of uneven reliability; in point of fact, a banker can really only count on his loan and investment portfolio and the discount window of his Reserve Bank. But even calling loans, quite aside from the implications for economic efficiency, is not generally feasible in the short run. And if we go back to the period before (say) 1940, we see that the possibility of quickly liquidating investments also largely disappears; except as provided by the Federal Reserve, secondary markets of sufficient size simply did not exist then. In the absence of a large stock of liquid assets, however, to merely quote current reserve requirements is to understate the impact on bank earnings. That is, if banks are to increase the probability of escaping penalty charges (moral and financial) for reserve deficiencies, they must hold excess cash — or be allowed free and easy access to a discount window. Thus, the discount mechanism has functioned historically not only to offset the direct impact of reserve requirements on bank earnings, but also as a defense against this further erosion of earning potential.

Of course, the discount mechanism has also served in the name of economic efficiency; this, if anything, has been its most cited rationale. In any earlier day, banks tried where possible to meet reserve drains by calling loans or correspondent balances, and where calls were impossible they reacted by refusing to consider new applications or requests for loan renewals. Yet such responses were clearly not optimum, even for the individual banks; at the macro-level, they created lasting difficulties in the form of liquidity panics. Here again, then, the discount mechanism has traditionally seemed to be an obvious answer.

This particular justification of rediscounting would seem, though, to pertain to an earlier era, that is, to the years before World War II. Just as with so many other aspects of monetary policy, the growth of the public debt — specifically, the growth in the stock of Treasury bills and certificates outstanding — appears to have made the difference (21). Commercial banks are now able to hold large quantities of liquid assets which can be used as a means of adjusting their reserve positions, as in fact they have been

(21) Professor SIMMONS seems to have been the first to point this out. See his "Federal Reserve Discount Policy and Member-Bank Borrowing", *Journal of Business* of the University of Chicago, January 1952.

in recent years. From the viewpoint of the individual member-bank, doing away with the discount mechanism is therefore distinctly feasible. Admittedly, there remains the macro-economic problem; but those who stress the possibility of undue pressure on market rates or of disorganized markets underrate the potential contribution of open-market operations and the ability of institutional arrangements to grow under the push of profit incentives. One can reasonably doubt that closing down the discount facilities would lead to sharper fluctuations in yields than those we have experienced since the Accord. Banks short of reserves would be forced to sell or run off their short-term holdings. Those in an opposite situation, however, would have a strong incentive — much stronger, it should be noted, than they have today — to retain the Treasury obligations already in their porfolios, and perhaps to acquire more. With market fluctuations thus limited, the task left to official open-market operations would be that much easier. Still, System purchases could be used when necessary to relieve general selling pressure, thereby enabling individual banks to unload their securities quickly and at no great loss. The judicious use of repurchase agreements with dealers in government securities would also help solve the problem of getting funds to particular banks. And so would other activities designed to expand government securities dealers' scope of operations, although clearly the adjustment to a world without a discount mechanism would take time.

The increase in the stock of short-term federal obligations outstanding has not wholly solved the problem of bank earnings (outlined above). Bills and other short-dated securities do pay a positive, if relatively low, rate of return, so that secondary reserves now have a lower opportunity cost than formerly; but this improvement in the earnings situation may not be sufficient to warrant abandoning our present discount arrangements: It is nevertheless questionable that the solution to this problem should be sought in the discount mechanism. Discounting does have definite implications for economic stability, and in this day and age these implications must be accepted as primary. That is to say, the future of the discount operation must be decided on the basis of its meaning for stabilization — especially since other solutions for the earnings problem (eg., lowering reserve requirements, or lengthening the computation period) are readily available.

Nor should the separate stabilization functions served by the discount mechanism be confused. The mere suggestion that we abandon our discount facilities may raise the spectre of 19th century financial crises, so it is well to emphasize that this proposal is not meant to question the desirability of having the central bank stand ready against true liquidity panics. That such a development is higly unlikely today does not matter; adequate safeguards against the extreme risks and dangers involved, since they cost so little, are really mandatory. Again, however, this does not imply that our present discount facilities are therefore essential. Strictly *ad hoc* arrangements would undoubtedly serve just as well for this purpose (22).

That closing down the regional discount windows appears feasible is not to say that it is thus the thing to do. We have so far only established an alternative to current policy, and there are others, as will be seen presently. But, which alternative should be adopted can only be decided in the light of our fundamental goal, economic stability. So, besides outlining the remaining alternatives, there is still before us the task of assessing the potential contribution of each possibility to the stability of our economic system.

B. *Professors Simmons and Smith on Current Policy*: The element of discretion bulks large in present-day discount policy. It is discretionary in the traditional sense; changes in, say, the official borrowing rate come deliberately, not automatically. Furthermore, it is discretionary in another sense; that is, Reserve Banks are not bound by law to make advances to any member-bank just because the latter is willing and able to pay the going rate. The question is whether these liberties are good or bad. Certainly the authorities must think of them as desirable. Yet it is this discretionary freedom which has drawn the fire of critics of Federal Reserve discount policy.

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(22) Mr. Balogh, in his paper "Dangers of the New Orthodoxy", *The Banker*, June 1956, has suggested that the Bank of England's present interpretation of the "lender of last resort" function is a misreading of the message of Bagehot's *Lombard Street*. Thus, he writes (p. 350): "Bagehot evolved his principle (the Bank as lender of last resort) in response to the failure of the Bank of England in the middle of the last century to stop liquidity panics by providing cash against sound security in case of need. This principle has no relevance to, and must not be used as an argument in favor of, the continuous use by the discount market of the Bank of England as a source of funds".

For example, Professor Simmons, commenting on the way in which the System allocates discount credits, has written that non-price rationing "... seems poorly suited to serve as a monetary control in a market economy" (23). He objects not only to the use (or better, possible use) of non-price eligibility conditions, but also to the failure to impose a true penalty borrowing rate and the continuing reliance on the reluctance of member-banks to borrow from the System. These objections are apparently based in part on philosophical considerations. More important for present purposes, though, is the analysis of the contribution of current policy to the goal of economic stability. Simmons makes the point that the combination of allocative devices presently being used reflects too strongly the Federal Reserve's long-standing sensitivity to the "needs" of the borrowing public, and that they cannot therefore be counted to effectively control the level of member-bank indebtedness. In particular, he doubts that the alleged unwillingness of banks to go to the discount windows is nearly so widespread as the authorities imagine, and hence feels that there is no real assurance that requests for borrowed reserves will not be very numerous. There is thus, for Simmons, an obvious danger in not employing a penalty borrowing rate or some other means by which System credit could effectively be rationed.

This idea that discount policy is even now limited by the Federal Reserve's concern for the "needs of commerce, industry and agriculture" is in a way rather persuasive. It must be admitted, of course, that this sensitivity is today less pronounced than at any time in the past. And yet something of it remains. System spokesmen continually insist that borrowing is a privilege, true, but it appears in fact to be treated more as a right of membership — at least in all cases where abuse is not flagrant (24). Such an approach is risky, however, when combined with the use of a non-penalty discount rate. It is dangerous, that is, to rely so much on the attitude of member-banks toward borrowed

(23) E. C. Simmons, "A Note on the Revival of Federal Reserve Discount Policy", *Journal of Finance*, December 1956, p. 420.

(24) This is the only conclusion which can be drawn from observations of regional Reserve Bank behavior; in particular, one cannot help but notice the way these banks hesitate before deciding to put pressure on member-banks which abuse their borrowing privileges. As one member of the Federal Reserve's official family put it: "Any bank with a good record can be virtually certain that it will get a loan".

reserves, especially when, because of their own traditions, the authorities are not in a position to move quickly in response to a change in this attitude. In fact, the only possible justification for taking such a risk is the fact that the System can perhaps still keep a hold on the over-all situation through its open-market operations. The issue therefore is whether or not there is some limit to the potential of the latter (25). In other words, can the System count on being able to make sufficient open-market sales — at a time, it should be noted, when the demand side of the market is likely to be weak — to offset an expansion of member-bank indebtedness, while at the same time honoring its commitment to prevent the development of disorganized markets (26)? Clearly, no one knows for sure; but this is not to say that the possibility of a negative reply can simply be assumed away. In any event, it is with this question in mind that some sense can be made of the criticisms of current policy which rest on the apparently perverse behavior of member-bank borrowings (see section II above).

Without being able to get inside the heads of Federal Reserve decision-makers, one can never be sure whether member-bank borrowing has ever gotten out of hand or whether actual developments have always been, so to speak, planned. It certainly seems that on occasion it has been the former, which is why Simmons would like to see some changes made. He does not advocate closing down the discount facilities; rather, he would prefer to move in the direction of establishing a true penalty rate — perhaps in part because of his feeling for what is appropriate in a market economy. But one would also have to grant that non-price rationing — while in principle no less effective than price rationing — is on occasion somewhat ambiguous in practice; inter-bank discrimination and unwanted expansions of System credit are therefore more likely. In a word, there is more room for human error. The non-discretionary approach should perhaps then be given a slight nod. But only a slight nod, even with regard to actual operations. For where, historically, excessive use has been made of Federal

(25) On this point, see W. L. Smith and R. F. Mikesell, "The Effectiveness of Monetary Policy: The British Experience", *Journal of Political Economy*, February 1957, p. 35.

(26) It should perhaps be mentioned here that the fact that individual banks try to get out of debt as quickly as possible is not so important as System spokesmen try to make out. The relevant figure is aggregate indebtedness, and this shows signs of falling off only when conditions of credit ease return.

Reserve facilities, the fault has been official reluctance and hesitation and not the uncertainties, of non-price techniques. The latter have been talked about, but little used. We shall return presently to this possibility of a greater reliance on non-price eligibility criteria, but before doing so some attention must be given to Professor Smith's critique of current policy.

In contrast to Professor Simmons, who is interested in the question of the appropriate level of the discount rate, Professor Smith is primarily concerned with the problem of rate administration (27). His thesis, in capsule form, is that changes in the discount rate, as carried out under the present policy, are if anything destabilizing in their effect. And this, as he sees it, is because these changes are made at the discretion of Federal Reserve officials.

Smith is inclined (and rightly, it would seem) to play down the influence of changes in the discount rate on businessmen's expectations. But he would also contend that where, say, rate increases do have an effect, they promote instability, not stability — the idea being that businessmen take such changes as grounds for optimism about the future. An even more important cause of instability, however, is the impact of rate increases on the expectations of market professionals. Traders and dealers, it is argued, pay close attention to the activities of the central bank, and use their resulting interpretations as a basis for forecasting the future. Because of this, the way is opened to possible misinterpretations of official intentions; and because traders and dealers play such an important role in securities markets, the way is also opened to unwanted, perverse fluctuations in market yields. For example, an increase in the discount rate which the authorities regard as "...merely a technical adjustment to preserve or re-establish a normal relation to other interest rates may be interpreted as a sign of a marked tightening of monetary policy and cause a sharp rise in long-term rates". Or the failure to make such an adjustment "...may create the expectation of a turnabout in monetary policy and cause a decline in long-term rates" (28). Now such developments, when they come to pass, are unfortunate because they tend to undermine overall monetary control. A sudden decrease in market yields, particularly if it follows a protracted increase, may as Smith points out bring

(27) "The Discount Rate as a Credit-Control Weapon", *op. cit.*

(28) *Ibid.*, p. 175.

forth a flood of capital issues heretofore held off the market; and, more importantly, a sudden increase in rates may force the authorities to relent in their (restrictive) open-market activities.

To remove once and for all the root cause of such difficulties, that is, the discretionary rate policy, Smith would have the Federal Reserve follow the lead of the Bank of Canada. The discount rate would then be tied directly to the Treasury bill rate by means of a well-publicized formula which would have built into it an appropriate yield differential (29). Thus, the official borrowing rate would vary only as the bill rate varied, so that there would be no room for interpretation, let alone misinterpretation. Quite simply, there would be nothing to interpret. The authorities could then feel free to press a restrictive monetary policy without having to worry about perverse yield movements arising out of their attempts to keep the official lending rate in line with market rates.

On *a priori* grounds alone there is no reason to suppose that Smith's "announcement effects" are any less plausible than those outlined in section II above (30). Moreover, his interpretation of post-Accord developments is quite convincing (31). It must be remembered, however, that while something is perhaps to be gained from following the course he advocates, something may also be lost. Market professionals do pay careful attention to what the Federal Reserve does, but this does not mean that expectational effects will necessarily be perverse. The point is that System policy-makers have in the open-market trading desk an excellent information source, and so, ideally, are in a position to either confirm or confound the expectations of the market (32). Confounding expectations may be a good idea; it all depends on what the authorities want to accomplish. But in adopting the non-discretionary approach,

(29) For details of the Bank of Canada's procedure and a statement of the reasons for its adoption, see the *Annual Report of the Governor of the Ministry of Finance*, 1956, pp. 45-6. This technique, as applied in the United States, would come out something as follows: each week the Federal Reserve would announce a discount rate computed from the average of the closing bill rates for the previous week or from the average bill rate established at the last bill auction.

(30) This reverse-twist was first presented by SAMUELSON in his paper, "Recent American Monetary Controversy", *Three Banks Review*, March 1956, p. 10n.

(31) *Op. cit.*; see especially notes 16-18, 20.

(32) To confirm market expectations is simply to do what is expected, and so minimize the reaction to the change in the discount rate. To confound expectations is to deliberately (or otherwise) set off a sharp reaction by doing the unexpected.

it is just this freedom to confound the market that is given up. Much depends therefore on one's estimate as to the likelihood that the practical difficulties outlined by Smith can be overcome within a discretionary framework.

C. *In Defense of Discretion*: Different as they are in important respects, the arguments and proposals of Professors Simmons and Smith can nevertheless be taken — without doing a serious injustice to either author — as comprising a single point of view. And in addition to a thorough critique of the discretionary elements in present-day policy, there emerges from this union an integrated proposal for a non-discretionary approach to the discount operation which can be put alongside our first major alternative to current policy (that of closing down the discount facilities). Of course, the feasibility of this second alternative depends entirley on the degree to which the discount rate is made to approximate an effective penalty rate. That a rather considerable differential between, say, the Treasury bill and discount rates would be required under the Simmons-Smith proposal follows from the fact that it would turn the central bank into a true " lender of last resort ". Member-banks, simply by paying the going rate, would be able to get borrowed reserves; only their profit calculations could limit their acquisitions. Clearly, then, if bank indebtedness were to be kept to a level which could be offset by open market operations, the rate spread would have to be larger than anything we have so far known. Indeed it might even be necessary to make provision for periodic adjustments in the rate differential, although this would be difficult to manage in a wholly non-discretionary way. Faced with a non-discretionary discount policy, member-banks would have no need to husband their secondary reserves against the possibility of (for example) a tightening of non-price eligibility conditions, and so would be tempted to run through their bill holdings quickly; but having done this, they might then find that the discount rate, when judged in terms of the assets still in their port-folios, was no longer a penalty rate (33).

(33) Although Smith does not make this point explicitly, he does seem to be well aware of it (*op. cit.*, p. 176n).

The establishment of a penalty borrowing rate could reasonably be expected to bring cries of pain from bankers and politicians alike. Presumably, however, cries would be no louder than those which would result if the discount facilities were closed once and for all; for given a true penalty rate in the Simmons-Smith scheme there is not much difference between the two alternatives. Admittedly, even with a penalty rate banks could, under the Simmons-Smith approach, borrow when faced with " last minute " reserve deficiencies; nor would the imposition of a relatively high borrowing rate stop-up completely the safety-valve which the authorities appear to value so highly (34). Yet these are precisely the features of present-day policy which (when considered in section III. A. above) were judged as being appropriate only to pre-war circumstances, or as fulfilling needs which were realistic only in a previous era, and so too much should not be made of them. It is more to the point to recognize that both alternatives would force member-banks to meet pressures on their reserve positions by selling from their investment portfolios; thus, more quickly than under the present arrangements, the banks would find that they would have to go to their long-term assets if they wanted to continue to expand their loan portfolios or if open-market operations kept them continually with their backs to the wall. Now if the Federal Reserve dealt as a matter of course over the whole maturity range of government securities, this aspect of these alternatives might not loom so large. Where, however, because of the " bills only " doctrine, open-market dealings are confined to the short end of the maturity structure, it must be regarded as crucial.

The apparent inferiority of current policy is not, even on the above count, due to its discretionary character. As was pointed out previously, there is no basis for thinking that non-price rationing is in principle any less effective than price rationing in curbing unwanted expansions of System credit; again, what has been wanting in Federal Reserve policy is a lack of will. Yet, this sort of argument is entirely too negative a defense of the use of non-price rationing techniques. The discretionary approach to discounting can be better defended by emphasizing the flexibility of this kind of policy, that

(34) For a sympathetic discussion of the need for " safety-valves ", see L. S. RITTER, " Income Velocity and Anti-Inflationary Monetary Policy ", which will appear in the March 1959 issue of the *American Economic Review*.

is, the power not only to control total indebtedness, but also to selectively control bank lending practices.

To point to the possibility of controlling the level (and perhaps even types) of bank loans is not to suggest that the control of the money supply is unimportant. It obviously is very important, more so than the control of any other single stock of assets. But at the same time it is not all-important, at least when inflation is the stabilization problem. The question at issue, then, is whether or not we should seek to control other asset stocks in addition to the money supply.

Commercial bank lending is a particularly important aspect of the total credit picture partly because it is closely associated with phenomena which have a special significance for the contemporary inflationary process — namely, inventory speculation and money wage increases. As a matter of business practice, the need which prompts a firm to seek outside financing helps determine the alternatives available. For example, if the contemplated expenditure is long-lived, a bank loan is a possible short-run substitute for open-market borrowing. But when funds are needed to finance an inventory buildup or an increase in transaction balances, a bank loan is more likely to be the only alternative available. Thus, to the extent that bank lending is held in check, employer resistance to employee demands for money way increases will probably be heightened. And where bank loans are not readily available firms will be less likely to speculate either in input requirements or their final outputs. Needless to add, both results would brighten the economic outlook.

In part, the effectiveness of an attempt to curb bank lending depends upon the extent of market imperfection — in particular, on the extent to which borrowers are able to shift between credit sources. If substitute sources are immediately available, it obviously does little good to limit access to bank loans. As was suggested above, however, firms are in some measure limited by their own conventions (35). And in addition it appears to be a fact of life that some borrowers simply have no alternatives beyond their local

(35) This is not to suggest that borrowers are therefore irrational. Under certain conditions the desire to match the length of the loan with the duration of the investment makes a good deal of sense.

bank (36). There does then appear to be some imperfection present currently, though it may be less extensive than formerly.

It should be noted that the selective control of bank lending can be effective even when credit markets are relatively perfect, for there is still the matter of timing and the cumulative nature of inflation. Where borrowers do have feasible alternatives to bank loans, the forces of custom or tradition and cost considerations nevertheless suggest that they will be investigated and utilized only after a lapse of time. Even where the response is immediate, the actual process of securing the substitute financing consumes some time. Nor is this a trivial consideration. Inventory speculation, particularly in commodities like steel which as inputs have an economy-wide significance, provides the very force which gives rise to " premature " price adjustments; and these price increases tend to cumulate through the rest of the economy. Once prices have been pushed up, the monetary authorities find themselves in a rather delicate position; they either have to expose themselves to the charge of economic irresponsibility, of having forced a downturn in economic activity, or else increase the money supply to accomodate the new, higher level of prices. At the very least, then, the control of bank lending could serve to compensate for the operation lag in general monetary policy (37).

To make use of the discount mechanism to selectively control bank lending would first of all require the establishment of appropriate non-price eligibility conditions (for example, a maximum figure for the ratio of loans to total loans and investments). And it would be necessary to keep the discount rate below the penalty level (38). If banks are to avail themselves of the System's discount facilities and thereby submit to the regulation of their activiets, it must in some sense be profitable for them to do so. (It might therefore be a good idea to increase considerably the charge levied

(36) In this connection, see R. F. Kahn, " Monetary Policy: A Symposium ", *Bulletin of the Oxford University Institute of Statistics*, April-May 1952; see also F. W. Paish and R. F. G. Alford, " How Interest Rates Cut Spending ", *The Banker*, August 1956, pp. 478, 481-3.

(37) The operation lag is measured as the amount of time it takes for a particular monetary policy, once instituted, to become effective.

(38) The administrative technique advocated by Smith could still be used, but the rate spread would have to be smaller than he suggests. It is possible, however, that the discount rate would never have to be changed, in which case perverse announcement effects would be no problem.

against banks having reserve deficiencies; in general, any measure which would increase the "cost" of non-compliance with Federal Reserve eligibility requirements would be all to the good). Moreover, the authorities would probably have to use open-market operations more aggressively than they have in the past: specifically, it would have to be made clear to member-banks in advance that open-market operations would not be employed to ease seasonal pressures on their reserve positions; and the banks could not be allowed to build up their secondary reserves during cyclical downswings. This is not to say that the System could never follow anything but a tight-money policy, but only that the periodic easing of credit conditions would have to come in part from a relaxation of borrowing eligibility conditions.

Too much should not be expected from this sort of policy, since it in a sense self-defeating. The selective control of bank behavior by means of non-price eligibility conditions on borrowing, if it is to be meaningful, must be closing off profitable opportunities. Thus, as the authorities would seek to accomplish more and more by their discount policy, they would be making their discount windows less and less attractive; and beyond a certain limit the member-banks would doubtless prefer to ignore the various eligibility criteria and take their chances in the open market. Yet, a discount policy which makes an attempt at selectively controlling bank lending may nevertheless be worth the bother. With monetary policy having to bear more and more responsibility for economic stabilization, we are at the point where every increase in effectiveness, however small, should be considered well worth the effort involved.

IV. Conclusion

Professor Simmons, in his analysis of present-day discount policy, has pointedly maintained that the Federal Reserve has as its goal "... much more than control of the size of the stock of money". "Control of lending", he feels, "is considered to be an equally if not more important objective" (39). And certainly the

(39) "A Note...", *op. cit.*, p. 417.

fact that System spokesmen have over and over again — in the light of the revised version Regulation A — reaffirmed as official doctrine the view that discounting is a privilege tends to confirm this interpretation of the aims of discount policy. Unfortunately, however, there is little in the Federal Reserve's actual behavior which would support Simmons' opinion. Its pronouncements notwithstanding, the regional Banks have throughout the post-Accord period continued to treat their discount facilities as a "line of credit" for their member-banks, and one is thus forced to conclude that all the talk about "right vs. privilege" has been pretty much intended only to reinforce the very reluctance which has always been attributed to commercial bankers. As a matter of fact, given the philosophy which seems to govern official thinking — and which is perhaps best characterized by the refusal of the Federal Reserve to take on even stand-by powers to control consumer credit — it would be something of a contradiction if the discount mechanism were looked upon as a means of selectively influencing bank behavior. And when it comes to the matter of direct or selective controls, the authorities are nothing if not consistent. Moreover, it does seem rather unlikely that this basic outlook, and hence current policy, will change in the near future.

In this instance, such a posture is to be regretted — particularly since the discretionary approach outlined above (section III. C.) appears to preserve the apparent advantages of present arrangements. Employing the discount mechanism to control bank lending is not inconsistent with its use either as a safety-valve or as a source of information about market conditions. But without a real desire to use the discount operation as a way of getting at bank lending practices — and this, it would seem, is precluded by their hostility to direct or selective control techniques — the authorities would be well advised to move in the direction of the Simmons-Smith proposal or of closing down the Reserve Bank discount windows altogether. The risks inherent in current policy would thereby be minimized, and without great loss; for, as the analysis of section III. A. indicates, the needs fulfilled by this policy are either no longer truly pressing or else can be better cared for in other ways.

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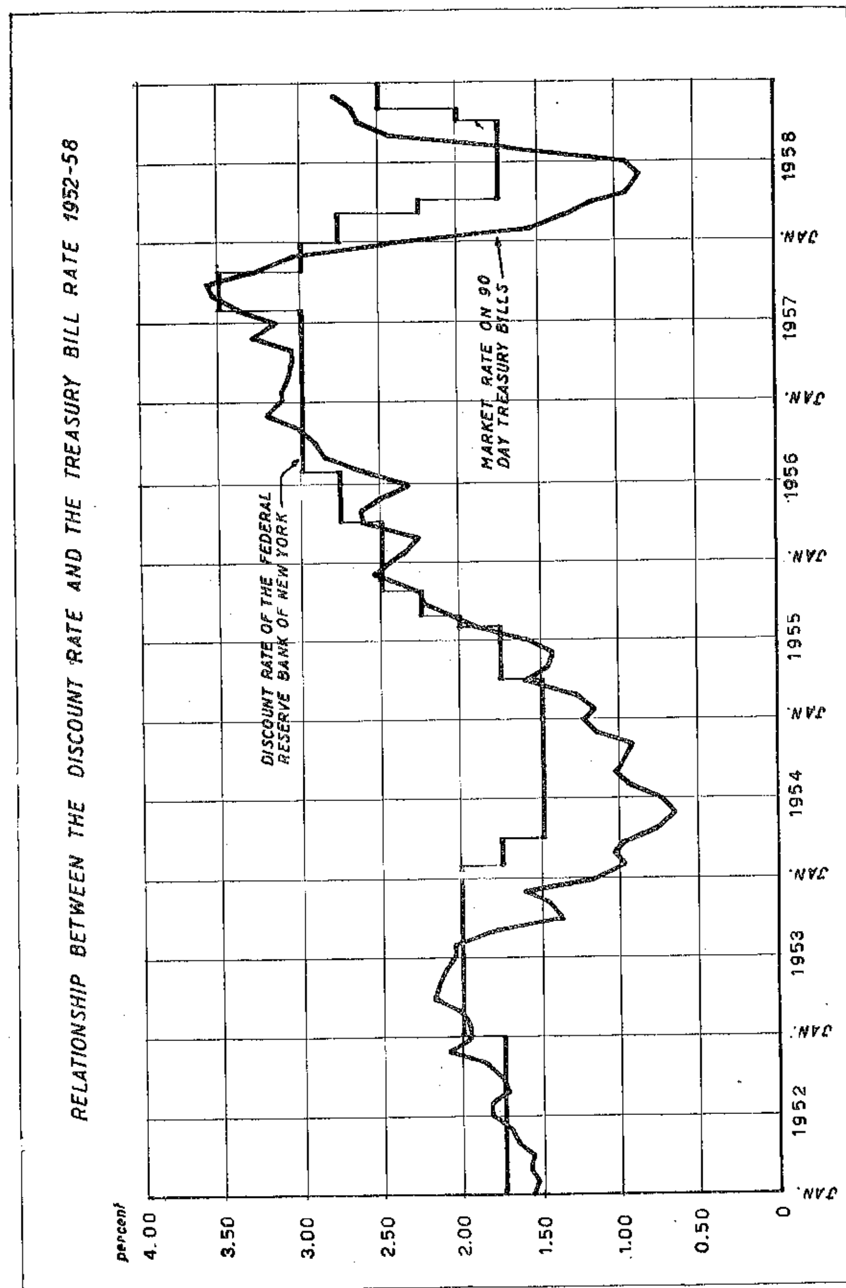
APPENDIX



MEMBER-BANK BORROWING, 1950 TO PRESENT

(in billions of dollars) *

	All Member-Banks	Central Reserve City Banks		All Reserve City Banks	All Country Banks
		New York	Chicago		
1950 I	.10	.04	.02	.03	.02
II	.08	.02	—	.04	.03
III	.13	.04	.01	.06	.03
IV	.12	.04	.01	.05	.03
1951 I	.26	.06	.02	.13	.05
II	.26	.08	.01	.10	.07
III	.27	.07	.01	.1	.05
IV	.37	.06	.02	.22	.06
1952 I	.30	.01	.06	.17	.05
II	.50	.11	.02	.28	.10
III	.93	.19	.05	.53	.16
IV	1.39	.27	.20	.73	.20
1953 I	1.29	.26	.30	.57	.16
II	.84	.12	.06	.45	.21
III	.51	.03	.06	.30	.13
IV	.43	.07	.03	.23	.11
1954 I	.19	.02	.03	.10	.06
II	.15	.01	.01	.07	.07
III	.09	.01	.01	.03	.04
IV	.16	.03	.01	.08	.04
1955 I	.38	.05	.08	.18	.08
II	.42	.01	.06	.22	.12
III	.71	.12	.07	.39	.13
IV	.91	.21	.10	.42	.13
1956 I	.87	.17	.15	.40	.14
II	.93	.10	.21	.48	.17
III	.81	.16	.07	.42	.15
IV	.72	.20	.12	.29	.11
1957 I	.63	.09	.12	.28	.14
II	.97	.23	.14	.43	.20
III	.97	.25	.06	.49	.17
IV	.77	.13	.11	.38	.16
1958 I	.28	.05	.02	.12	.09
II	.13	.01	—	.05	.07
III	.28	.06	—	.14	.08
IV	.55	.06	.07	.27	.15

* The figures given are quarterly averages of daily indebtedness.

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