429

FEDERAL RESERVE DISCOUNT MECHANISM

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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CONTENTS

Witnesses and Statements

SEPTEMBER 11, 1968

	Page
Proxmire, Hon. William, chairman, Joint Economic Committee: Opening remarks	1
Letter from Chairman Proxmire to Gov. William McChesney Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System	2
Mitchell, Hon. George W., member, Board of Governors of the Federal Reserve System, and Chairman, Intrasystem Committee on Reappraisal of the Federal Reserve Discount Mechanism; accompanied by Howard H. Hackley, Assistant to the Board, Federal Reserve; and Robert Holland, Secretary of the Federal Reserve Board	3
Table: Summary of proposal for redesign of discount mechanism	9

SEPTEMBER 17, 1968

Proxmire, Hon. William: Opening remarks	31
Letter from Milton Friedman, professor of economics, University of Chicago, containing comments for the record	32
Robertson, Ross M., professor of business economics and public policy, Indiana University	34
Ritter, Lawrence S., professor of finance and chairman of the Department of Finance, New York University Graduate School of Business Administration	38
Gies, Thomas G., professor of finance, University of Michigan Graduate School of Business Administration	43

Submitted Statements

American Bankers' Association: Statement submitted by Wesley Lindow	70
Independent Banker's Association of America: Statement submitted by T. H. Milner, Jr., president; and Bradford Brett, chairman, Federal Legislative Committee of the IBA	72
U.S. Savings & Loan League: Statement submitted by Richard T. Pratt, economist	74
Board of Governors of the Federal Reserve System: Letter responding to comments submitted for record by Prof. Milton Friedman	78

FEDERAL RESERVE DISCOUNT MECHANISM

WEDNESDAY, SEPTEMBER 11, 1968

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in room S-407, the Capitol, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senator Proxmire; and Representatives Reuss and Brock.

Also present: John R. Stark, executive director; John R. Karlik, economist, and Douglas C. Frechtling, minority economist.

Chairman PROXMIRE. The committee will come to order.

In opening these Joint Economic Committee hearings, I would like to observe that they are in line with this committee's considerable interest in economic policy. Our subject this morning concerns the recent report, sponsored by the Board of Governors, setting forth a proposed revision in the Federal Reserve discount practices. As I have indicated before, it would have important consequences for the nonbanking financial institutions, particularly savings and loan companies and mutual savings banks. Our purpose this morning and in a sequel hearing next week is to attempt to assess exactly what significance these changes would have if adopted.

We have with us today Gov. George Mitchell who has been the Chairman of the Intra-System Committee on Reappraisal of the Federal Reserve Discount Mechanism. Other members of the committee included:

Gov. Sherman J. Maisel; Gov. William W. Sherrill; President Karl R. Bopp, Philadelphia; President Edward A. Wayne, Richmond; President Charles J. Scanlon, Chicago; President George H. Clay, Kansas City; and Chairman William McC. Martin, ex officio.

Governor Mitchell, in a moment I am going to ask you to summarize or explain to us the rationale and implications of your report. First, however, I would like to turn to a different subject; namely, this committee's report setting forth standards for guiding monetary action which requested certain reports from the Federal Reserve Board to this committee. There has been correspondence between Chairman Martin and me since that time, the most recent letter being Chairman Martin's of September 9. There has been a good deal of press interest in the committee's reaction to the Chairman's letter, and I would therefore like to take this occasion to say that I have just dispatched a letter to Mr. Martin, and I am releasing it to the press now. Since it is short, I will read it here:

"SEPTEMBER 10, 1968.

"Hon. WM. McC. MARTIN, Jr.,
"*Chairman of the Board of Governors of the Federal Reserve System, Washington, D.C.*

"DEAR MR. CHAIRMAN: This is in response to your letter of September 9 regarding reports by the Federal Reserve Board to the Joint Economic Committee.

"Your proposal that the Federal Reserve submit an analysis of significant developments following every calendar quarter, taking into account changes in the money supply as well as other types of deposit, strikes me as a very useful and mutually beneficial measure. Consequently, I would appreciate your instituting such reporting practice as soon as it reasonably can be done.

"With respect to annual staff projections of financial developments, requested by the Joint Economic Committee, it appears that there has not been a complete meeting of the minds as yet. The Joint Economic Committee would not expect predictions as to the future course of monetary policy, of course. I do not think any central bank should be expected to make precise predictions as to future monetary policy actions. On the other hand, the committee would expect the Federal Reserve to go beyond the submission of projections—"

And I am quoting now the letter that Governor Martin wrote me—

" 'consistent with the economic prospects envisaged in the President's Economic Report.'

"We would like to have such projections. But, more important, we would also wish to have your best judgment as to the acceptability of those projections and, in the event that you do not agree with them and anticipate basing your policy on different projections, the committee would like to hear about them.

"The Federal Reserve has taken the position quite properly on previous occasions that it is not required by law to be responsive to the will of the executive branch in its economic policy decisions. Consequently, it is conceivable, although I do not think likely, that there might be differences on occasion between the Federal Reserve's judgment and that of the administration on the economic outlook. In such case, it would be a duty of the Federal Reserve, as an agency of the Congress, to give the Congress its best judgment as to the economic outlook, including monetary factors.

"I hope that this clarifies our expectations.

"Very truly yours,

"WILLIAM PROXMIRE, *Chairman.*"

Governor Mitchell, I certainly do not expect you to comment on this issue which I am raising with the Chairman of the Federal Reserve Board this morning. I took this occasion, because I thought it was a timely occasion to report publicly on my response to Chairman Martin.

You have prepared a very helpful and thoughtful paper which I had a chance to study last night, on the new discount mechanism. I think it has all kinds of interesting implications, and we are very happy to have you go right ahead on that.

STATEMENT OF HON. GEORGE W. MITCHELL, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND CHAIRMAN INTRASYSTEM COMMITTEE ON REAPPRAISAL OF THE FEDERAL RESERVE DISCOUNT MECHANISM; ACCOMPANIED BY HOWARD H. HACKLEY, ASSISTANT TO THE BOARD, FEDERAL RESERVE; AND ROBERT HOLLAND, SECRETARY OF THE FEDERAL RESERVE BOARD

Mr. MITCHELL. Thank you, sir. It is a pleasure to be here and testify before you once again on this day to talk about our report on the proposed changes in lending facilities to member banks.[1]

The studies and research on which the Report is based were undertaken to be sure our lending operations—properly called our discount mechanism—were appropriate to present-day banking institutions and environment. To be more effective in meeting changing community credit needs, commercial banks need central bank assistance as well as supervision. We are pleased to discuss our findings with you.

The redesign suggested by the Report would represent the latest in a whole series of evolutionary changes in Federal Reserve lending policies and procedures. When first established by the Federal Reserve Act in 1913, the discount mechanism was expected to operate by member banks presenting certain types of short-term customer notes—termed "eligible paper"—as collateral for borrowing at the Reserve banks. During most of the first 20 years of Federal Reserve operation, member banks borrowed a sizable proportion of their total required reserves on the security of such customer notes.

After 1934, however, member banks accumulated large amounts of Government securities and other liquid assets; accordingly, they did very little borrowing from their Federal Reserve banks, and collateralized such borrowing as they did with Government securities. This marginal role for the discount window was formally recognized in a change in 1955 in the Board's regulation A covering loans to member banks; under that revision, bank borrowings from the Federal Reserve were to be limited to assistance over the peaks of temporary, seasonal, or emergency needs for funds that exceeded the dimensions that the banks could reasonably be expected to meet out of their own resources.

In the last decade or so, however, credit demands on banks have grown and loan-to-deposit ratios are much higher, rising from 47 percent to 60 percent. Moreover, at many banks portfolio management has pared liquidity positions substantially, and borrowings from sources other than the Federal Reserve have expanded enormously. In addition, a small but growing number of banks has also been led to withdraw from membership in the Federal Reserve System, chiefly in order to avoid reserve requirements and thus enable them to invest a greater portion of their resources in earning assets. In view of these developments, the proposed redesign of the discount mechanism is aimed at relating Federal Reserve lending more clearly and closely to the changing banking and community needs.

Before I outline the new proposals which have been made for our lending facilities, it might be well for me to mention three longstand-

[1] Report: "Reappraisal of the Federal Reserve Discount Mechanism."

ing basic principles of Federal Reserve lending that were reaffirmed by our study.

First among these is that Federal Reserve credit is extended primarily to accommodate bank asset and liability adjustments over limited time periods and to meet essentially short-term fluctuations in member bank needs for funds.

In short, no continuous borrowing.

The second principle reaffirmed, however, is that Federal Reserve banks always stand ready to lend to any of their member banks caught in special regional or local adversities—such as droughts, drastic deposit drains, or other emergencies—for as long as reasonably needed for the bank to work out of these circumstances.

Thirdly, the Report recognizes that the Federal Reserve serves as "lender of last resort" to buttress the entire financial system in the event of widespread emergency. Within the limits of existing law, and lending primarily through member banks as intermediaries, the Federal Reserve is prepared to supply liquid funds to other types of financial institutions when such assistance is not available elsewhere and is necessary to avoid major economic disruption.

Along with these continuing principles, the Report suggests several modifications of lending operations to better serve emerging needs. Let me summarize the main new suggestions briefly, and then outline each one in somewhat greater detail.

To provide more clear-cut access to Federal Reserve lending facilities, the Report proposes that each soundly operated member bank be given a "basic borrowing privilege," enabling it to borrow up to a specified limit from its Reserve bank upon request in as much as half of its weekly reserve periods.

In addition, it is proposed that any member bank foreseeing large seasonal bulges in its needs for funds would be able to arrange for loans from its Reserve bank to meet such needs in excess of a specified minimum. This arrangement, more explicit and more liberal than currently provided, is termed the "seasonal borrowing privilege."

Member banks experiencing drains of funds that are not of a seasonal or emergency nature, but that are bigger or longer in duration than can be accommodated under the new "basic borrowing privilege," could also arrange for additional credit pending an expected and timely reversal of their fund outflows or an orderly adjustment of their assets and liabilities. Such borrowings would be subject to essentially the same kinds of administrative procedures now applied to similar situations.

A final innovation proposed by the Report is to make the discount rate—the interest rate charged by Federal Reserve banks on their loans to member banks—more flexible than heretofore. It is recommended in the Report that the discount rate be changed considerably more frequently and by smaller amounts, keeping it reasonably closely in line with the movements in other money market rates.

Turning now to some of the major features of these recommendations, the most commonly used of the new lending provisions for member banks in sound condition would undoubtedly be the basic borrowing privilege. The size of each bank's basic borrowing privilege would be established as a proportion of some base drawn from the bank's balance sheet; the current proposal suggests capital stock and surplus. Required reserves could also be used.

Frequency of use of the basic borrowing privilege would also be limited. This is necessary because Federal Reserve credit is not properly a long-term or permanent addition to the loanable funds of individual member banks. The aim is to make credit available over a long enough period to cushion the bulk of short-term fluctuations or portfolio adjustments and in most cases permit orderly adjustment to longer term movements of funds.

The proposed frequency limitation would allow assured and virtually automatic access to credit so long as the bank is indebted in no more than half the reserve periods in the specified interval.

Before the plan is finally made effective, choices will be made in the light of comments received as to the particular percentages which would apply to the amount and frequency limitations. The controlling considerations will be that individual credit access should not be so small or so infrequently available as to be insignificant to the member banks, nor should total access be so liberal as to interfere with Federal Reserve open-market operations aimed at carrying out national credit policy objectives.

Borrowing within the basic borrowing privilege limitations could, as noted, take place virtually upon request, unless the Rserve bank had notified the member bank that its overall condition was unsatisfactory as determined by such factors as adequacy of capital, liquidity, soundness, management, or noncompliance with law or regulation and that such unsatisfactory condition was not being corrected to the Reserve bank's satisfaction. The only other circumscription on the actions of a qualified borrowing bank would be the avoidance of net sales in the Federal funds market during the reserve periods in which it was borrowing from the Federal Reserve. This administrative rule, already in force, is retained in the new proposal in the interest of precluding retailing operations in Federal Reserve credit obtained through the discount window.

It is recognized that the basic borrowing privilege as I have been describing it would not be large enough to encompass every member bank's needs for funds in all instances that justify the use of discount credit. This is particularly true in cases of the larger banks which borrow infrequently but for rather large amounts, but it is also true in cases of smaller banks faced with sharp temporary drains of funds. Arrangements are therefore recognized as necessary to permit member bank borrowings outside the basic borrowing privilege up to the limits of appropriate needs on as convenient and understandable terms as possible. These arrangements, referred to in the Report as "other adjustment credit," would be available pending an expected and timely reversal of fund outflows or an orderly portfolio adjustment. Such borrowings would be subject to essentially the same kinds of administrative procedures and surveillance now applied to similar situations, with the precise timing and nature of administrative actions determined as at present by the circumstances surrounding individual cases. Close contact among the Federal Reserve Board staff and the Federal Reserve banks' discount officials will be maintained in the interest of dealing uniformly with similar cases.

The third general category of credit which would be available to member banks at the proposed discount window is called the "seasonal borrowing privilege." A reserve bank would be prepared to establish such a seasonal borrowing privilege for any member bank experi-

encing demonstrable seasonal pressures persisting for a period of at least 4 consecutive weeks and probably longer, and exceeding a minimum relative size. It is expected that this borrowing privilege would be of value principally to smaller unit banks in agricultural or resort areas in which seasonal swings have a substantial impact on the entire community and where access to the national money markets or other adjustment resources is not always readily available.

The existence of seasonal pressures would be judged on the basis of past years' patterns of loan and deposit fluctuations. The establishment of a qualifying seasonal swing in net availability of funds—defined as deposits minus loans to customers in the bank's market area—would ordinarily be fixed by negotiation once a year. Once the existence of a qualifying seasonal need was established, the reserve banks would agree to extend discount credit up to the qualifying amount and for the length of time the need was expected to persist, up to 90 days. The 90-day maximum is imposed by statute; however, should the need extend over a longer period than this, the reserve banks would regard renewals of credit as in accordance with the initial seasonal credit negotiation. Seasonal credit needs would normally be expected to last for several months, but in exceptional cases could range up to us much as 9 months, we believe.

Seasonal credit obtainable at a reserve bank would be limited to the amount of the borrowing bank's seasonal swing in excess of a specified percentage of its average deposits in the preceding year. This "deductible" principle, requiring a bank to meet a part of its seasonal needs out of its own resources, is designed to encourage individual bank maintenance of some minimum level of liquidity for purposes of flexibility. It would also serve effectively to limit the aggregate amount of credit extended under the seasonal borrowing privilege to an amount consistent with overall monetary policy, while allowing the Federal Reserve to provide this assistance to all those member banks with relatively large seasonal needs.

The proposed redesign of the discount window would provide that the Federal Reserve continue to supply liberal help to its member banks in emergency situations. So long as the member bank is solvent and steps are being taken to find a solution to its problems, credit would be available on the same basis as it currently is, and, within the limits of the law, special and flexible arrangements would continue to be made where necessary. Assisting a bank in an emergency situation would generally require credit extension for periods longer than would normally be allowed at the window, but this would be expected and regarded as appropriate.

The Federal Reserve, in its role as lender of last resort to other sectors of the economy, may find it necessary to extend credit assistance to institutions other than member banks. This action would be taken only when other sources of credit have been exhausted and failure of the troubled institutions would have a significant impact on the economy's financial structure. When lending to nonmembers, the Federal Reserve would act in cooperation with the relevant supervisory authority to insure that steps are taken to find a solution to their problems. The Federal Reserve Act authorizes direct advances to nonmembers, but only if collateralized by U.S. Government securities. Since most nonmember institutions of the types apt to require

emergency credit assistance do not have sizable holdings of this asset, credit would normally be extended through a conduit arrangement with a member bank. Most types of nonbank financial institutions have borrowing relationships with their commercial banks as a matter of course and, ideally, this indirect lending by the Federal Reserve could fit in with such business practice. Such credit would be provided at a higher rate than the basic discount rate.

The proposed discount window does not include the provision of intermediate- or long-term credit to meet the needs of banks servicing credit-deficit areas or sectors—that is, areas or sectors where the opportunities for profitable investment continuously outstrip the savings generated locally. While this is recognized as a problem of some significance, it was concluded that its solution lies outside the proper scope of the discount window. The steering committee concluded that an appropriate and effective solution to this problem was most likely to be found in the improvement of secondary markets for bank assets and liabilities. Detailed studies of the feasibility of actions to promote such improvement are expected to begin in the near future.

I should emphasize that Federal Reserve open-market operations are still envisioned as the main tool of monetary policy. The proposed changes in discount operations, however, would alter to some degree the current relationship between these two methods of reserve injection, with the discount mechanism assuming a somewhat increased role. This would come about as a result of the accommodation of more of the day-to-day fluctuations of reserve needs at the window, the improved distribution of reserves brought about by injection of some reserves directly at the point of need, and more flexible and effective use of the discount rate as an influence on bank borrowing. The first and second of these benefits would entail a generally higher level of borrowing being done by a typically rotating group of member banks. But this is not conceived to mean a corresponding increase in total reserves or a loss of control in this area, since the Federal Reserve would retain the ability to bring about and maintain the desired level of overall credit availability, taking into account the relatively small increase expected in credit outstanding at the window, through purchases and sales of securities in the open market.

To simplify my oral remarks this morning, I have avoided citing specific numbers, technical conditions, or underlying statistical evidence associated with the proposed changes in the discount mechanism. For your convenience, I have summarized these details in the two-page appendix table attached to my statement. If you have any questions about such matters, I will be glad to answer them either now or in subsequent correspondence.

Let me emphasize that all these details are provisional at this stage, and subject to review and modification in the light of our study of the comments and reactions received. The proposal at this stage represents a report of a Federal Reserve committee. The Board of Governors has not yet taken any substantive action on the proposals contained in the Report nor published any change in its Regulation A which governs borrowing. We have already received a good many comments on the Report from a variety of sources, including both bankers and banking organizations and others. We have had assistance from the reactions

and suggestions of numerous academic scholars; several leading economists have contributed analytical papers on one question or another related to the discounting area; and the Board has scheduled two different seminars with a number of professors of economics at which ideas on this subject could be profitably exchanged.

I can assure you that the views expressed in these hearings also will be taken into account by the Board.

As we now see it, the shape of the proposal under consideration can be encompassed within the framework of existing legislation. It may be, however, that certain aspects of the studies and of comments received might make it desirable for the Board to request some amendments in the language of certain governing statutes in order to permit the revised discount mechanism to be as effective as possible. As you know, the Federal Reserve has already proposed a bill—S. 966—popularly termed the "eligible paper" bill—which would make certain changes in the provisions of the Federal Reserve Act relating specifically to lending to member banks. It would seem likely that most, if not all, of the changes suggested by our studies could be encompassed by the language in that bill. Of course, neither the eventual changes which might be made in the mechanism nor any resultant need for legislation can be finally settled at this stage, but at a somewhat later date we may need to address a communication to the Congress regarding the pending, or possibly additional, amendments to the statute.

All of us involved in this reappraisal recognize that, even after any of the suggested changes were introduced, a period of transition would undoubtedly be required before the full potential of the discount mechanism could be realized either by the Federal Reserve or the member banks. However, I believe that there is a good possibility that this redesign can bring this mechanism in closer touch with the prevailing economic climate and lead to a more effectively functioning banking system that is better equipped to serve evolving needs of the community.

(The table appended to the statement follows:)

SUMMARY OF PROPOSAL FOR REDESIGN OF DISCOUNT MECHANISM

	Basic borrowing privilege (1)	Other adjustment credit (2)	Seasonal borrowing privilege (3)	Emergency credit to member banks (4)	Emergency credit to others (5)
Definition	Member bank access to credit upon request, within precisely stated limits on amounts and frequency and on specified conditions.	Supplemental discount accommodation, subject to administrative procedures, to help a member bank meet temporary needs that prove either larger or longer in duration than could be covered by its basic borrowing privilege.	Member bank access to credit on a longer-term and, to the extent possible, prearranged basis to meet demonstrable seasonal pressures exceeding minimum duration and relative amount.	Credit extended to member banks in unusual or exigent circumstances.	Credit extended to institutions other than member banks in emergency circumstances in fulfilling role as lender of last resort of the economy.
Rate	Discount rate	Discount rate	Discount rate	Discount rate	Significant penalty above discount rate.
Quantity limitations	——— (20 to 40) percent of 1st $1,000,000 capital stock and surplus plus ——— (10 to 20) percent of next $9,000,000 of plus ——— (10) percent of remainder.	None specified	Seasonal needs in excess of ——— (5 to 10) percent of average deposits subject to reserve requirements in preceding calendar year.	None specified	None specified.
Frequency or duration limitations	——— (6 to 13) of any ——— (13 to 26) consecutive reserve computation periods.	do	Need and arrangement must be for more than 4 weeks. Maximum 9 consecutive months.	do	Do.
Administrative procedures	None other than general discouragement of net selling of Federal funds by borrowing banks.	Appraisal and, where necessary, action broadly similar to procedures developed under existing discount arrangements.	Prearrangement involves discussion between discount officer and bank management concerning amount, duration, and seasonality of need. Administrative review maintained during borrowing to prevent abuse or misuse.	Continuous and thoroughgoing surveillance. Require that bank develop and pursue workable program for alleviating difficulties.	Continuous and thoroughgoing surveillance (may have to be through conduit). Require that institution develop and pursue workable program for alleviating difficulties.
Other restrictions	Must not have been found to be in unsatisfactory condition.	None specified	None specified	None specified	Required to use all other practicable sources of credit first.
Method of provision	Direct	Direct	Direct	Direct	(1) Through central agency; (2) direct; (3) conduit through member bank.

Chairman PROXMIRE. Thank you very much, Governor Mitchell, for, as I say, a statement which I enjoyed studying last night. The bill you mentioned, S. 966, that was my bill, the Proxmire bill?

Mr. MITCHELL. Yes.

Chairman PROXMIRE. It passed the Senate and is now in the House, as I understand it.

Mr. MITCHELL. That is right.

Chairman PROXMIRE. If it doesn't pass the House in the remaining, we hope, few days—2 or 3 weeks—we will probably have another crack at it next year.

Mr. MITCHELL. We would like very much to see that bill pass.

Chairman PROXMIRE. Well, I hope it will.

Now, in looking at the overall effect of this new proposal, just in terms of quantity, I see the charts that you have helpfully attached to your statement at the back give us some idea in terms of quantity limitations, definitions and so forth, and the report by the Board of Governors indicates that the maximum credit extension which could currently result under your plan is estimated at between two and a half and $3.8 billion, but that is only for the basic borrowing privilege.

Mr. MITCHELL. That is right.

Chairman PROXMIRE. It would not include the so-called additional what do you call it——

Mr. MITCHELL. Seasonal.

Chairman PROXMIRE. There was another one which seemed to be much bigger the way you described it—the second.

Mr. MITCHELL. Other adjustment credit?

Chairman PROXMIRE. Other adjustment credit.

Mr. MITCHELL. Yes.

Chairman PROXMIRE. Yes, because you indicated that the larger banks especially might come in under that to a considerable extent, and then the seasonal in addition. Do you have any estimate as to how much that might increase it at the maximum?

Mr. MITCHELL. Well, I don't think we really know what credit might be outstanding at any given time. The amounts mentioned are the maximum exposure.

Chairman PROXMIRE. I understand that and I was going to come to that point. I would take it 2.5, 3.8, you would never have that much, 3.8 for example, out, under any circumstances?

Mr. MITCHELL. That is right.

Chairman PROXMIRE. Because as you say this has to be averaged. You have to go down to—they can't make full use of their borrowing privilege all the time. They have to pay it off.

Mr. MITCHELL. The seasonal credit should not be a very large amount, for the reason that it probably is not going to apply to any large banks.

Chairman PROXMIRE. That is just perhaps $300 or $400 million.

Mr. MITCHELL. Something of that order, possibly.

Chairman PROXMIRE. Now, how about the other one?

Mr. MITCHELL. I don't think the additional adjustment credit would add more than a few hundred million dollars, if it would add that much. At the present time we have the equivalent of basic borrowing, and other adjustment credit and seasonal credit, and we run from $300 million to $800 million or $900 million.

Chairman PROXMIRE. So the impact on the money supply or the impact on the amount of credit would be in the area of, say, $2 billion perhaps?

Mr. MITCHELL. Well, we don't intend that there be any net impact. There would be a gross impact, but we would absorb any increase here.

Chairman PROXMIRE. I understand that.

Mr. MITCHELL. Yes.

Chairman PROXMIRE. Before we come to the absorption.

Mr. MITCHELL. Yes.

Chairman PROXMIRE. Which you would adjust by your open-market operation.

Mr. MITCHELL. That is right.

Chairman PROXMIRE. Would be in the area of perhaps $2 billion?

Mr. MITCHELL. Yes, I think $2 billion to $3 billion, you might see this amount on our balance sheet.

Chairman PROXMIRE. Now, this would mean that you would buy $2 billion to $3 billion less?

Mr. MITCHELL. Yes.

Chairman PROXMIRE. Of the Government securities.

Mr. MITCHELL. Yes.

Chairman PROXMIRE. And to the extent that there is a difference in the interest rate on your discount operation, and on the Government securities, which you forego buying, the Treasury would possibly suffer a loss in revenues. When you buy Government securities, that interest goes back to the Treasury pretty much.

Mr. MITCHELL. Yes, it does; sure.

Chairman PROXMIRE. Now, to the extent that you have discounts, discount interest, discount rate——

Mr. MITCHELL. Yes.

Chairman PROXMIRE (continuing). Which is equal to your average Treasury rate, there is no loss.

Mr. MITCHELL. I think over a period of time that is right; you would have a loss if the discount rate is below the bill rate, but if it is above it you would have a gain. I think over time there wouldn't be very much to be gained or lost either way.

Chairman PROXMIRE. In the last few years you have had a situation where the discount rate has been perhaps a little bit below, I think.

Mr. MITCHELL. Yes. Well, you see, part of the proposal is to make the discount rate more nearly like the family of market rates with which it is identified. In periods of monetary restraint—and these are the periods in which you get the major amount of borrowing—it is fair to say the discount rate has been lower than the complex of market rates, but this proposal is to keep it more nearly in line.

Chairman PROXMIRE. The reaction I had when I read about that is that this might be a good thing for the Nation to have and it has a lot of excellent public-interest implications but there were some problems possibly for some nonmember financial institutions.

I understand it, the restrictive impact of a tight monetary policy, for example, largely falls not on the commercial banking system but on the nonbank financial intermediaries for these reasons.

Commercial banks can circumvent a tight-money policy by selling off Government bonds, attracting funds by raising their rates offered

on certificates of deposit, and by borrowing on the Euro dollar market. Savings and loan associations can't do that. In 1966 this was well demonstrated. Commercial banks weren't hit nearly as hard as the non-commercial-bank financial institutions. So that, since the restrictive monetary policies are carried out through nonbank intermediaries, doesn't the Federal Reserve System have at least an equal obligation to make its discount facilities available to these institutions, the non-commercial banks, on the same terms available to commercial banks? Wouldn't this be a good idea?

Mr. MITCHELL. Well, it presents quite a few problems, I think, that would make it difficult for us to provide the same facility to, say, non-member banks and to nonbank financial institutions. We don't have anything to do with examination or with the inspection of these institutions, and what we know about their operations does not compare with the detailed information that we have on the operations of member banks.

Now, while I think it is quite true that there have been——

Chairman PROXMIRE. Of course, they are under the jurisdiction of competent, careful Federal agencies.

Mr. MITCHELL. That is right.

Chairman PROXMIRE. With which you have worked closely?

Mr. MITCHELL. Yes.

Chairman PROXMIRE. And which could establish criteria?

Mr. MITCHELL. And as I indicated in my statement, on the few occasions when we have extended credit to nonmember banks, we have worked very closely with the FDIC, the agency involved, but we have not as far as I can recall extended credit to anybody else, except indirectly through the banking system. Even though the discount mechanism has a cushioning effect, nevertheless, as long as the credit is not continuous, it does not enable a bank to do anything more than postpone its adjustment, and for a relatively short period of time. The bank must get back into position by reducing its assets—selling off some of its Government securities or letting some of its loans run off—or attracting more deposits, or borrowing someplace else.

Now, all of these methods of adjustment are practiced to one degree or another by every type of financial institution. It happens, I think, to be true that banks are more skillful, and have more opportunities to use alternative methods of adjustment.

Chairman PROXMIRE. You see, this has an overall economic effect that concerns me, and I am sure concerns other Members of Congress, very seriously. If banks are able to adjust in the ways I have suggested here, so that they have funds available to loan to the business community, and this is what happened in 1966——

Mr. MITCHELL. Yes.

Chairman PROXMIRE (continuing). The business community can go ahead and expand full tilt in spite of a restraining monetary policy, whereas housing, which is dependent on the savings and loan, takes the full crunching burden of restriction, and in that year went into a real depression with a very unfortunate social and economic effect.

Mr. MITCHELL. Yes; but in 1966 you know business loans came to a halt, too, and one important function that the commercial banks perform is to provide a market for State and local securities.

Chairman PROXMIRE. But in the crunch of 1966 you had an enormous increase in business investment in plant and equipment.

Mr. MITCHELL. Well, up until September. Then the expansion stopped.

Chairman PROXMIRE. It slowed down some.

Mr. MITCHELL. It slowed down to zero.

Chairman PROXMIRE. But you didn't have a reversal, where housing starts went down to a level of 800,000 a year for a period of some months.

Mr. MITCHELL. Yes. Well, I am not attempting to dispute the fact that in the 1966 episode housing contracted very severely. All I am saying is that it was not confined to housing.

Chairman PROXMIRE. If we don't open up this discount mechanism, and I agree that there are, some very serious problems involved, what effect is this new measure going to have? Isn't it likely to aggravate the discrimination in favor of commercial banks and business as opposed to housing in the future even more than it has been in the past?

Mr. MITCHELL. Well, I don't think so. I think that the nonbank financial institutions, thinking mainly about the S. & L.'s, have the Home Loan Bank Board that they can go to and borrow not for just temporary periods but for lengthy periods and the loans involved here are in the order of several billion dollars if I recall correctly.

The loans that we are talking about in the banking system are short-term, and are for the purpose of enabling those banks that use the discount facility to adjust their asset and liability position to changing monetary conditions. Now, you should have some kind of a safety valve, anytime you are tightening monetary policies. The banking system has to have a little time to make its adjustment.

Chairman PROXMIRE. You had a situation in 1966 in which banks were able to make their loans as you stipulated up until about September. In September they found that the crunch was beginning to have some effect. Now if you had this kind of a provision in September, would they then begin to hit the discount window in a lot bigger way, especially with your second provision here, the emergency provision? And if not, why not? And if not, does this have any real effect?

Mr. MITCHELL. Well, if you had had a discount window like this one——

Chairman PROXMIRE. Right.

Mr. MITCHELL (continuing). You could, I think, have applied more monetary restraint through open market operations, because you would have had a better safety valve for the banks that got into distress conditions.

Chairman PROXMIRE. The open market operation, the general broad monetary effects were hitting the savings and loans, as I say.

Mr. MITCHELL. Yes.

Chairman PROXMIRE There were various ways in which the commercial banks were able to insulate themselves. Now you give them another.

Mr. MITCHELL. But you know what hit the savings and loan associations was the escalation in interest rates. They had an asset structure based on a return of something between five and five and a half percent, and all of a sudden they found they couldn't get funds at that rate, and it was the market that they were fighting, rather than the commer-

cial banks. The market rates were furnishing them with their main competition.

Now, the commercial banks have a more flexible position by the nature of their operation. Their asset portfolio is not as long term, and in a relatively short period of time they can make an adjustment in their asset position to a new level of interest rates, but S. & L.'s simply can't do that, and it is the nature of their operation that they can't do it. And I don't think discounting would solve their problem unless the discount credit was for a very extended period of time.

Representative BROCK. Mr. Chairman, would you yield for a question?

Chairman PROXMIRE. Yes, indeed.

Representative BROCK. Mr. Mitchell, isn't it true that whereas banks operate on a 60-percent basis, 60-percent-loan-to-deposit ratio, your S. & L.'s are generally at 98, 99, and 100 percent.

Mr. MITCHELL. Yes, that is right.

Representative BROCK. They even borrow their liquidity.

Mr. MITCHELL. Yes.

Representative BROCK. So there isn't any comparison of the two situations because you can't borrow more than 100 percent hopefully over any period of time anyway, and the point is that the banks, by being far more strictured in terms of requirements reserves and so forth by the Federal Reserve than the savings and loans are, by the Home Loan Bank Board, the banks have more flexibility. They are always going to have more flexibility because they have more reserves. They have a better position.

Mr. MITCHELL. They have more liquidity.

Representative BROCK. More liquidity. And there is no way to equate the situation when the S. & L.'s are loaned up to 100 percent. Isn't that the real difference of what you are talking about?

Mr. MITCHELL. And of course the savings and loans essentially, I think, operate on the basis of their flows, and they project the flow, and with this flow they make their commitments, and banks operate on the basis of flows plus a fairly substantial liquidity cushion.

Chairman PROXMIRE. Governor Mitchell, I would like to call your attention to some of the figures that we have—what actually happened in 1966. We find the total investment, nonresidential investment, that is, business investment primarily, increased from 1965 and 1966 from $71 billion to $81 billion, in 1967 it was $83.6 billion, continued right through, in the last quarter of 1967 was the biggest investment of all during the year, $84.2 billion, in fact it went from $82.6 billion in the third quarter to $84.2 in the fourth quarter. There isn't any question that the business investment continued to go up, and of course this wasn't entirely because of the bank loans, but this was one of the sources of it, at least it didn't result in a contraction or reduction.

Now, contrast that with what happened in housing. Housing went down, in 1965 it was 26.7, in 1966 it was 24.3, 1967 it was 24.0, and so forth. It went down so that by the first quarter of 1967 it was down to 20.5.

Furthermore, paralleling this you have a very unhealthy situation in business inventories, which are traditionally and largely financed by bank borrowing. Business inventories went from $6.1 billion in 1966 to $12.8 billion in 1967. As a matter of fact, in the fourth quarter

of 1966 they had gone up to $19.8 billion. So that it looks as if you have in way or another a situation, even without this kind of provision, to make it easier for the banks to secure funds.

You are right, in the long run they have to iron this out but it is easier for banks to adjust to monetary policies. You have, absent this, a record showing that banks were able to adjust in such a way that their business customers were able to expand at a very rapid rate, even at an unhealthy rate, during the period of monetary restraint.

Mr. MITCHELL. Well, banks did take care of their business customers as long as they could, but in the summer of 1966 corporations were forced into the capital markets, and the funds for a continuation of the expansion of plant and equipment and in inventories came more from that source than from bank loans, once banks shut down on the expansion in their total credit. I think it is perfectly true that the banking system has a large amount of allegiance to the business community, because that generates a very substantial part of their deposits. But also it has a very substantial allegiance to consumer credit and to mortgage credit. It holds a lot of both of these. And it serves a very diversified area. It finances the U.S. Government. In fact, the banking system is the underwriter for U.S. Government securities.

Chairman PROXMIRE That is true. Of course, the banking community, the banking institutions perform an absolutely essential service outside of business.

Mr. MITCHELL. Yes.

Chairman PROXMIRE. But I think most of us feel, at least I feel that their prime customers are business.

Mr. MITCHELL. The large banks—that is true.

Chairman PROXMIRE. The large bank with a large amount of loanable funds; and for obvious reasons, if I were in banking, I would feel the same way. You take care of your biggest and most important customers.

Mr. MITCHELL. Yes.

Chairman PROXMIRE. You have to do it. Either that or you don't succeed.

Mr. MITCHELL. But I want to say that the changes in the discount mechanisms that are proposed here, are oriented more toward the small- and medium-sized banks than they are toward the large banks.

Chairman PROXMIRE. My time is up. I will be back.

Congressman Brock?

Representative BROCK. Just to pursue that for a moment, isn't it true that banks more and more are getting into consumer credit?

Mr. MITCHELL. Yes.

Representative BROCK. In a larger percentage of their business which is going that way, and also there is more emphasis on homeownership.

Mr. MITCHELL. Yes.

Representative BROCK. They are getting into this field. Now they have been limited by regulation?

Mr. MITCHELL. Yes.

Representative BROCK. Primarily in terms of the length of the loan.

Mr. MITCHELL. Yes.

Representative BROCK. Which has pretty well precluded them from competing with the savings and loans in this particular area; isn't that so?

Mr. MITCHELL. Yes. Banks have become more competitive and they have been enabled to become more competitive in this area by changes in the regulations.

Representative BROCK. When they could make, say, only a 15-year loan as opposed to 30-year loan?

Mr. MITCHELL. Yes.

Representative BROCK. It is very difficult to compete in terms of repayment.

Mr. MITCHELL. That is right.

Representative BROCK. They had trouble getting into the area just by the nature of the industry, the fact that they are a quick turn industry. They make their money by shorter term loans. Let's pursue that area of nonmember institutions that you might make loans to. Give me a couple of illustrations, would you, of the situation that might occur.

Mr. MITCHELL. Well, the first area of nonmember institutions are nonmember banks.

Representative BROCK. Let me ask you to comment, as you comment on nonmember banks, if you are going to get into this to any degree, if you are going to make loans to nonmember banks, what incentive is there for a bank to be a member.

Mr. MITCHELL. Well, there would be very little unless member banks have readier access to discount credit, at more favorable rates, than nonmembers. I don't think we should extend credit to nonmember banks on the same terms that we do to member banks, because member banks on the average have to keep nonearning assets with us in the amount of roughly 10 percent of their deposits.

Representative BROCK. You would charge maybe a quarter of a percent more or something like that?

Mr. MITCHELL. Well, the law requires us to charge at least a half a percent more on advances secured by the kind of assets you could except the borrower to pledge.

Representative BROCK. A half a percent?

Mr. MITCHELL. Yes.

Representative BROCK. Do you consider this to be a significant area, and yet you say it is not significant, so what are you saying?

Mr. MITCHELL. Member banks' total deposits are $375 billion, and nonmember bank total deposits are $75 billion. And that doesn't sound very large compared to member banks, but if you can keep these numbers in mind for a moment, the comparable figures are $63 billion for mutual savings banks and $128 billion for savings and loans and $4 billion for credit unions. Now, these are the three or four categories of institutions that presumably might be involved. I might add insurance companies in there, but the relationships between insurance companies and commercial banks are such that I think they would find it perfectly normal and natural to turn to their commercial banks for credit, if they needed it, rather than to us.

It is true, too, that in 1966 savings and loan borrowed over a half billion dollars from commercial banks.

Representative BROCK. You are saying that you would use a commercial bank as a conduit.

Mr. MITCHELL. As a conduit, that is correct, yes.

Representative BROCK. Now, can you envision a situation in which all the other financial institutions in the country were at a crisis point, they had no liquidity, in which the commercial banks had liquidity?

Mr. MITCHELL. Well, we would have to provide the liquidity to the commercial bank that was servicing the other institution. No, I can't, to answer your question. We all have to be in the same boat, in the situation you have postulated.

Representative BROCK. And if you are in the same situation where everybody is lacking liquidity, can you imagine a situation in which a commercial bank would want to act as a conduit to a savings and loan as opposed to a major industrial customer of theirs?

Mr. MITCHELL. Well, they would if their capacity to accommodate that savings and loan were taken care of by the Federal Reserve.

Representative BROCK. But they can take care of customers first and then the savings and loans?

Mr. MITCHELL. Well, if the lender has a continuing relationship with the borrower, he knows something about the borrower's condition and his prospects and the like, and this grows up into quite a fund of knowledge and understanding.

It is far better to keep the established borrowing-lending relationships and use them rather than to substitute a new one. I think that is all I am really saying.

Let me put it this way. The Federal Reserve has an enormous fund of day-to-day information about the operations of member banks The Reserve banks know management policy, they know management personnel. They get daily reports on assets, on liabilities, and extremely complete reports on what is happening at every member bank, plus the regular examinations which take place once a year.

Now, that is the kind of fund of understanding which underlies the discount operation, but if you are talking about extending discounts to nonbank financial institutions, or to people who are nonmembers, you are not talking about the same kind of understanding at all.

Representative BROCK. I don't think we are arguing. I think I am just questioning the logic of your approach.

Mr. MITCHELL. I think this is essentially the logic of restricting a discounting operation pretty much to regular relationships.

Representative BROCK. All right, let's take 1966. Would you have, if you had had this available at that point, would you have made loans to savings and loans using the commercial banks as a conduit?

Mr. MITCHELL. We were prepared to. We were not asked to. We had the structure all set up at that time though it was not used.

Representative BROCK. You were prepared to do so?

Mr. MITCHELL. We were prepared to do it. We stood ready to do it, and we advised them that we would.

Representative BROCK. What would have happened if banks had been as tightly strictured as the savings and loans? You still would be prepared to make loans?

Mr. MITCHELL. Well, in fact many banks were hard pressed.

Representative BROCK. Yes I know.

Mr. MITCHELL. And in the so-called September 1 letter, which I am sure you have all heard of, we simply said, "You are entitled to discount credit, provided you indicate the nature of the steps you are taking to get back into adjustment."

Representative BROCK. A savings and loan that is part of an industry which has borrowed up to 100 percent goes to the Home Loan Bank Board, and they borrow all they can. They reach the limit there, and the Home Loan Bank Board has given out all the money they have got available for lending to institutions across the country. At that point then they would come to you; is that correct?

Mr. MITCHELL. Yes.

Representative BROCK. And you would treat it just as a very short-term device?

Mr. MITCHELL. Well, if the country were in a liquidity crisis, I think you would have to think in terms of an environment like that in the 1966 situation.

Representative BROCK. What worries me is that it seems to me that you are assuming the functions of the Home Loan Bank Board here. You are stepping in that direction, and I wonder——

Mr. MITCHELL. I don't think so.

Representative BROCK (continuing). If we probably shouldn't address our concern to their situation. If you are going to expand reserve ability——

Mr. MITCHELL. The difference is that the Home Loan Bank Board is extending relatively permanent credit without asking how the borrower is going to achieve a balance between its own assets and liabilities. When we extend credit we require that the borrower show how it will get back in balance and we provide only a limited time in which to do it. That is the difference.

Representative BROCK. I am not sure the Home Loan Bank Board is going to appreciate your getting into that area.

Mr. MITCHELL. We don't want to get into it until it is necessary, and we are simply standing ready to supply liquidity for good assets.

Representative BROCK. Do you honestly believe that this is not a major addition to the reserve portfolio of banks?

Mr. MITCHELL. What is that, sir?

Representative BROCK. Isn't this honestly a major addition to the reserves of banks right now?

Mr. MITCHELL. Well, I think it would make it possible for the smaller banks and banks with seasonal requirements to adjust their positions more conveniently than they can now. Let's take an example.

Representative BROCK. The ability to adjust is dependent upon your reserve situation.

Mr. MITCHELL. Well, when we are pushing in a period of monetary restraint, when the banks' reserves are not growing as rapidly as the economy would like to have them grow, then banks can get in an overcommitted position, and the discount window gives them a little time to get out of that overcommitted position. Now they can get out of the overcommitted position in lots of ways.

They can buy Federal funds, they can advertise for CD's. They can solicit additional demand deposits. They can borrow from their correspondent banks, or they can cut back on their assets.

Representative BROCK. All right. Any time you get into a problem situation, a problem time for the industry——

Mr. MITCHELL. Yes.

Representative BROCK (continuing). It is generally going to be a time of tight money?

Mr. MITCHELL. Yes, that is right.

Representative BROCK. Because you are imposing——

Mr. MITCHELL. That is right.

Representative BROCK (continuing). A restriction on money in order to cope with an inflation situation?

Mr. MITCHELL. Yes, that is right.

Representative BROCK. And at the very time that you say you are imposing restraints you make available $2 to $3 billion?

Mr. MITCHELL. No, it is not net. It is not on a net basis. This just has to do with the distribution of reserves over the banking system. If your target for reserves, let's say——

Representative BROCK. But in a tight-money situation every bank is going to be coming to you for this money?

Mr. MITCHELL. No, no. Banks do not all behave the same. Some of them had excess reserves, even in 1966.

Representative BROCK. Yes, a few; but most of them suffered a little bit under the tight money.

Mr. MITCHELL. Well, I know some large banks that got their positions adjusted in the fall of 1965, and I know some that didn't get adjusted until September of 1966.

Representative BROCK. That is right.

Mr. MITCHELL. And later.

Representative BROCK. Some might have in 1966. It looks like it is contradictory to me. I am not sure that you can really treat this thing as a sponge and raise one section and lower another.

Mr. MITCHELL. If you decide as a matter of monetary policy on a particular level at which you want reserves, you see, that level is determined by the amount of Federal Reserve credit outstanding through Government securities, float and discounts. If you have more discounts, you will have less float or less Government securities in the Federal Reserve's portfolio. You don't change this level because of what is happening——

Representative BROCK. You honestly adjust your open market policy?

Mr. MITCHELL. That is right.

Representative BROCK. You say you don't buy bonds on the market?

Mr. MITCHELL. That is right. You buy less bonds. You slow the rate of growth in those holdings, because you are supplying reserves through discounts.

Representative BROCK. So by not buying bonds you force them to sell their bonds on the open market and you are going to have a high price for bonds, aren't you?

Mr. MITCHELL. You know, all of these monetary effects go together.

Representative BROCK. That is right. Well, I am interested in seeing how it goes. I wish you well. Thank you very much.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

I want to congratulate you, Governor Mitchell, and your committee members for what I think is a very constructive report as I see it. It does about three things.

First, it shifts some emphasis from open market policy to the discount window, and says that all occupants of the Federal Reserve

apartment house do not have to keep their apartment at exactly the same temperature. They are to have individual thermostats.

Second, you promise some indirect relief, at least, for nonbanking institutions in times of stringency.

Third, you would, I believe, very largely do away with the unfortunate announcement effect of Federal Reserve discount changes by linking the discount rate fairly closely to market instruments, by which I take it you mean the Treasury bill rate and associated rates?

Mr. MITCHELL. That is right.

Representative REUSS. All of which seem to me steps forward, and that is why I am very happy about your report. In your statement here this morning, you refer, Mr. Mitchell, to the fact that a small but growing group of banks "has also been led to withdraw from membership in the Federal Reserve System, chiefly in order to avoid reserve requirements, and thus enable them to invest a greater portion of their resources in earning assets."

You don't quite say so, but there seems to be implicit in your statement there the idea that this relatively greater kindness to member banks via the selective nature of the discount window would induce more banks to stay in the System. Am I drawing an unjustified inference?

Mr. MITCHELL. No; I don't think you are, although the committee in its report didn't say that this was a significant consideration. I don't think that we in the Federal Reserve System are unaware or unperturbed by the fact that we have been losing quite a few members.

Now, in 1957 we had 48.8 percent of the banks, and now we have 44.9.

While we haven't shrunk that much in total assets—we have declined from 85.2 to 83.3 percent—a significant number of banks have left the System, and there are some very large banks outside of the Federal Reserve System that I really think ought to be in it.

Representative REUSS. I raise this question because I would hope that you wouldn't want to rely on these discount window changes as a method of keeping banks in the system. My own belief is that the Federal Reserve ought to be able to regulate reserve requirements, whether or not a bank is a member of the System. If you could do that, you then wouldn't have to worry about whether something you are going to do is going to offend some banks.

Mr. MITCHELL. Well, that is right, but that is another one of our proposals that I gather is languishing.

Representative REUSS. I wish it wouldn't languish. I think it is a good proposal. I would like to get that out of mothballs.

In your statement this morning, with respect to the Federal Reserve acting as a lender of last resort for the entire financial system, you say that "the Federal Reserve is prepared to supply liquid funds to other types of financial institutions when such assistance is not available elsewhere and is necessary to avoid major economic disruption."

That is the savings and loan question which you have been discussing with the chairman and Mr. Brock?

Mr. MITCHELL. That is right.

Representative REUSS. Is this something new or are you merely codifying what the Fed has been groping toward in recent years?

Mr. MITCHELL. It is essentially what we did in 1966, when we set up these relationships. This just reaffirms what was done at that time.

Representative REUSS. Of course, I like this. It seems to me that while the Home Loan Bank Board is the lender of first resort for the savings and loan system, its rescue ability is limited.

Mr. MITCHELL. Yes.

Representative REUSS. This was proved by the stringency of September 1966. And I think it is all to the good that the Fed stands ready to back up the Home Loan Bank Board, in seeing that financial intermediaries, largely savings and loans, aren't bereft of lending power because of overall monetary stringency.

Mr. MITCHELL. Could I just put in the record here, Mr. Reuss, that on the first of July 1966——

Representative REUSS. 1966?

Mr. MITCHELL. Yes, July 1, 1966, we did adopt a policy entitled "Credit Facilities for Nonmember Depository-Type Institutions," and it says among other things:

> The Board advised the Federal Reserve banks that in order to provide for prompt implementation of such a program, if needed, it had taken the following action, effective immediately and until September 1, 1966.

This was subsequently renewed.

"Member banks in your district are permitted, pursuant to"—the sections of the act—"to use as security for advances from your Bank, whether under section 13 or 10(b) of the act, assets acquired from mutual savings banks and other banks that are not members of the Federal Reserve System, but only in accordance with, and subject to, specified limitations."

There were other provisions covering S. & L.'s.

Now, this program was adopted and is the same program that is reaffirmed in the letter, and it was adopted and renewed on two occasions. It is not presently in effect, because there seems to be no need for it.

Representative REUSS. How do you make certain that a bank to whom you give access to the discount window under these circumstances is actually going to turn around and re-lend that money to a beleaguered savings and loan?

Mr. MITCHELL. Since we have never done it, I just assume——

Representative REUSS. But how would you do it?

Mr. MITCHELL. Well, we would do it, I presume, because the bank would come to us saying it has the request for funds for this purpose, and the funds would be dispersed just on that basis and for that purpose, and withdrawn after the loan was repaid.

Representative REUSS. In your report itself, on page 18, you point out that you are somewhat inhibited in lending directly to savings and loans under the existing law by the fact that advances must be secured by "direct obligations of the United States."

Mr. MITCHELL. Yes.

Representative REUSS. And savings and loans don't have enough of those direct obligations in their portfolios to be meaningful borrowers.

Mr. MITCHELL. Yes.

Representative REUSS. Why wouldn't it be a good idea to ask Congress to amend that provision of the law? It would seem to me that in a time of severe housing stringency, for example, that the Fed should

have the power in conjunction with the Home Loan Bank Board to lend directly to savings and loans.

Mr. MITCHELL. I see no objection to that. I think it should be done. But in point of fact, under the existing law this is quite a stricture on their capacity to borrow directly.

Representative REUSS. And you would favor removing that limitation?

Mr. MITCHELL. Yes.

Chairman PROXMIRE. Would you yield just for a minute on that? I think that is a most interesting and useful observation. Of course you speak for yourself. Do you know if this is the view also of other members of the Federal Reserve Board?

Mr. MITCHELL. No, sir.

Chairman PROXMIRE. Have they ever expressed this to you?

Mr. MITCHELL. No. I just don't know.

Chairman PROXMIRE. You don't know if there is or is not?

Mr. MITCHELL. I don't know if there is or is not.

Chairman PROXMIRE. In your view, however, this would be perfectly proper as well as in the public interest.

Mr. MITCHELL. I think it is appropriate to relax the——

Chairman PROXMIRE. The collateral.

Mr. MITCHELL. The collateral standards that are imposed in the statute, yes.

Chairman PROXMIRE. The only collateral they would have would be mortgages presumably in any substantial amount.

Thank you.

Representative REUSS. In your earlier responses to questions from the chairman and Mr. Brock, Governor Mitchell, I thought I understood you as saying that the Fed couldn't really do very much to help out the Home Loan Bank Board and the savings and loans in times of stringency, because savings and loans lend long and the discount window is short, and thus not much could be done.

I wonder if it is really as gloomy as all that. The problem in 1966 in September was that the savings and loans had a considerable withdrawal of their short-term deposits, and also a failure to make new short-term deposits in anything like the ratios they wanted. I would have thought that short-term discount window help for the savings and loans, either directly or through banking intermediaries, would be meaningful, that it would enable the savings and loans to tide themselves over until they could improve the interest rate of their long-term portfolio.

Mr. MITCHELL. Well, I don't know the degree to which they were getting assistance from the Federal Home Loan Bank System at that time.

Representative REUSS. Very little, actually.

Mr. MITCHELL. Many of them had borrowed for expansion purposes up to the point where the bank board would not extend any further credit to them, and I am not sure that many of them would have been induced by an arrangement of this kind to resume making new loan commitments.

It is true that loans by commercial banks to savings and loans reached a peak about that time of about $550 million, so they were getting some credit. The S. & L.'s in the summer, in July—I guess June is the peak month—had $572 million in loans from commercial

banks, and whether this was adequate or not adequate I don't know. Part of the problem with the savings and loan associations at that particular juncture was that some were in very bad shape in terms of the quality of their assets, not in terms of liquidity at all. It was an asset problem. I am not sure, you may be right.

Representative REUSS. Let me sum up this phase of the discussion and ask for Chairman Proxmire's attention.

Chairman Proxmire in the Senate, and I and others in the House in recent months flirted with the idea, as you know, of having the Federal Reserve help out the savings and loans and the home building industry by buying either directly or through the open market securities of Home Loan Bank Board and FNMA and similar agencies.

The Fed rebuffed us quite firmly on this, saying, "No, we don't want any directive to have any particular portfolio mix," and the Fed in fact has not to this date bought any, or perhaps I should say any appreciable amount, of these housing-oriented securities.

Well, we have taken our lumps on that. But I am wondering if you don't in this report of yours, offer a way of help through the central monetary authorities for savings and loans, and the home building industry, that could be very meaningful and in a way agreeable to you, the Fed. In other words, can't you do without disquiet to yourself, through the discount window, what you objected being told to do through the open market mechanism?

Mr. MITCHELL. Well, at this point I don't know whether you are talking about going directly to S. & L.'s or going through a conduit.

Representative REUSS. Either way.

Mr. MITCHELL. Yes.

Representative REUSS. I think that which you do indirectly you might as well do directly, but either way.

Mr. MITCHELL. Yes.

Representative REUSS. If the bank actually turns around and makes the loan it helps the savings and loans in time of need, so that they can adjust their long-term portfolio to a more favorable interest rate, and meanwhile they aren't strangled by the withdrawal of deposits or the failure of new deposits to come in at an appropriate ratio.

Mr. MITCHELL. Well, the committee—I am talking now about the committee that produced the report—I don't think it had any particular misgivings about banks, commercial banks, extending credit that they thought was appropriate to savings and loan associations, and if necessary, if it were a question of liquidity, and there were no question involved about the quality of the assets, for them to make use of the discount window in order to accommodate this, and I don't see any objection to this.

I think, I don't know that we won't have another crunch worse than in 1966, but I think all of us that lived through it hope we can avoid another, and as I say, even then the system's standby emergency procedures weren't actually used. Credit was supplied by the commercial banking system to the extent it was done, and the home loan banks.

Representative REUSS. Well, I may be too optimistic and may be reading too much into this section of your report, but as I see it, Senator Proxmire, I and others may be winning a great victory without firing a shot.

Mr. MITCHELL. Those are the best kind.

Representative REUSS. One final question, on the announcement effect, you say, on page 20 of the Report, that if these recommendations are adopted the discount rate would be very close to the Treasury bill rate, I think is what you really mean, and you don't say in this report exactly how often you would vary it, but presumably 15 days, once a month, something like that, within the range of possibility.

Mr. MITCHELL. Well, let me just say that the Treasury bill rate is not an infallible index of the complex of money market rates. Sometimes it gets way out of line, either on the up side or the down side. And the reason we haven't tied to it is just that.

Now, in periods when you are getting, you know, changes in the monetary climate and changes in the money market rates, then the discount rate would change quite often, and by relatively small increments, a quarter or an eighth even, instead of a half or something of that sort.

I think this implies that most announcement effects of the rate change are only felt by people who are professionals in the business, and the general announcement effects——

Representative REUSS. Will be felt in the future if this is adopted.

Mr. MITCHELL. Yes. The general announcement effects would not be noticed if the rate were changed frequently.

Representative REUSS. Yes.

Mr. MITCHELL. They would be noticed by professionals in the market, just as they noticed the RP rate change, when a small change was made there recently.

Representative REUSS. I think this is good.

Mr. MITCHELL. Yes.

Representative REUSS. Because in the past I have felt that the Federal Reserve from time to time has done things it ought not to have done or left undone those things which it ought to have done, because it has been afraid of the announcement effect.

Mr. MITCHELL. Yes.

Representative REUSS. There have been instances.

Mr. MITCHELL. That is right.

Representative REUSS. In the published reports of the open market committee where this obviously played a role, and to the extent that we can eliminate this phony language of flowers whereby the Fed is supposed to be communicating things through the discount rate, I think we will get a more orderly market. Isn't that what was in the minds of the committee?

Mr. MITCHELL. Yes; I think that is right. There is another view which did not prevail, and which I don't think is felt as strongly, that there are occasions when you want announcement effects, but they are relatively rare.

Representative REUSS. Hasn't that view been happily rejected by you and your committee?

Mr. MITCHELL. Yes; predominantly rejected, that is right.

Representative REUSS. Yes.

Mr. MITCHELL. But I wouldn't want you to have the impression it is not still alive. But I think even the people that hold the view that announcement effects are sometimes good were perfectly prepared to admit that in many cases they are bad.

Representative REUSS. Wouldn't you agree with me that if the Fed wants to announce something, it should do it in plain English and say what it means, and should not talk this mystique through discount rates?

Mr. MITCHELL. I don't want to be facetious at this point, but there are problems of semantics involved in the system. There are seven members of the Board of Governors and there are five more reserve bank presidents on the Federal Open Market Committee, and the semantic problem of saying exactly what you want to do is pretty large. It isn't that easy. To do something is one thing, and to say, "I did it because" is something else again, and this is a real problem in dealing with the announcement effect.

I think there are some times when an action does speak for itself, and I really think that position is entitled to that much consideration. But this is the case I would say only one out of 10 times, with the change in the discount rate. The other times you are better off, you know, doing it gradually, so that the markets are more orderly, and I think the reaction of the markets to what the system is doing is better.

Representative REUSS. There is still plenty of time for putting the Federal Reserve Committee's views on the discount rate and its announcement effect in more precise form prior to the promulgation of your draft regulation which as I understand it will presumably come in a few months.

Mr. MITCHELL. Yes; that is right.

Representative REUSS. I would hope that when you do that, you would make the changes in discount rates as automatic as possible. You have just said that nine times out of 10 the discount rate change, if this new system is adopted, would be automatically geared to money market changes.

Mr. MITCHELL. In terms of the way we operate it now it is nine out of 10. It would probably be more under this system where you would have changes in the rate maybe every month or every 2 weeks.

Representative REUSS. I would think so.

Mr. MITCHELL. So there would be even fewer times when an announcement effect would be desirable. But this is one of the problems that seriously concerned the study committee.

You don't want to give up any measure that helps your monetary control, and if there are times when an announcement effect is desirable, maybe it shouldn't be given up completely. And I think it is consistent with the proposal of the committee to use this, well, let me say 19 out of 20 times in the way in which you have interpreted it. On that 20th time we might use it with an announcement effect.

Representative REUSS. This brings me to my point. I would hope that when you promulgate your regulations, you will indicate that where there is intended to be an announcement effect, you are going to say so.

Mr. MITCHELL. Yes.

Representative REUSS. Otherwise you are going to vitiate the whole exercise.

Mr. MITCHELL. Yes.

Representative REUSS. Because the world will think there is a hidden announcement effect in every one of these changes.

Mr. MITCHELL. Yes.

Representative REUSS. And without capitulating to Milton Friedman, it seems to me that the Fed could, as to the discount rate, tie it pretty precisely to such a conglomerate of money market instrument rates as you wish, and say so in advance in the regulation.

Mr. MITCHELL. Yes.

Representative REUSS. And provide for a band, when reserves are scarce, let the discount rate as you suggest be a little on the lower side in terms of its relationship to the money market rate, and then provide that upon occasion, the Fed may vary from this automaticity, but that when it does it will say so.

Mr. MITCHELL. Yes.

Representative REUSS. And give its reasons. I think if you did that you would achieve an excellent purging of that announcement effect.

Mr. MITCHELL. Yes, I agree.

Representative REUSS. Thank you, Mr. Chairman.

Chairman PROXMIRE. Earlier this year the Banking and Currency Committee of the Senate voted by an 8-to-4 margin, as you know, to provide that under certain circumstances the judgment and initiative being entirely within the Federal Reserve Board, the Federal Reserve Board would buy the obligations of the Home Loan Bank Board. This is what Congressman Reuss is referring to.

We had a terrible fight on the floor on this, because the Federal Reserve went all out against us. I have never seen Chairman Martin so exercised. This to him seemed to be the end of the world. He felt that this would certainly be the end of the Federal Reserve, and I never could understand why he was so concerned.

In the first place, we limited it to $2 billion.

In the second place, we left it entirely to the initiative of the Federal Reserve as to whether or not they should step in, the situation being sufficient to warrant their coming to the assistance of the housing industry.

As I say, there was a substantial vote in committee. Because of the opposition of the Federal Reserve, we lost on the floor by one vote. But there is this sentiment in the Congress for considering ways and means in which our monetary system can be so adjusted that it doesn't do what it has done to the housing industry.

I just can't understand the Fed's opposition, and I would appreciate an answer from you, Governor Mitchell. I have great respect for you.

Why is it that there is such opposition to an authority that relies on the judgment of the Federal Reserve itself, the only guideline being when in its judgment the housing industry seemed to require it, because no other funds were available, and limiting it to, say, $2 billion, why is there such opposition to this?

Mr. MITCHELL. Well, I don't think I should undertake to answer that. I might comment on it. I recall one monetary scholar who suggested that a central bank could have a portfolio of grandfather clocks if they wanted to and still operate monetary policy. You can think of a portfolio of assets which includes almost everything, and you can say that you could really run monetary policy with something like this. Of course, you know that some of it has to be sold, as well as bought; and grandfather clocks may be easier to buy than to sell.

Now, bringing it down from this academic position into the realm of reality, I think that the thing that perturbs the Federal Reserve System, and I think this is a general view in the System, is that if we open up to investment a particular category of security, whose sellers or whose beneficiaries are having difficulty in selling this security, then we are going to be under a series of pressures from the various agencies and interests to invest in this particular security and to hold it, and to be careful how we sell it, and to avoid coming into the market when the security is being offered or securities of this type are being offered in order to disturb the market.

Chairman PROXMIRE. The pressure won't be against you. It would be on the Congress. Congress would have to pass a law similar to the one that we tried to pass to authorize you to go ahead in your judgment. Then you would be under pressure.

Mr. MITCHELL. Well, we would be under pressure. You said you were going to leave this to our judgment.

Chairman PROXMIRE. You would be under pressure in this particular instance.

Mr. MITCHELL. Yes.

Chairman PROXMIRE. But not with regard to any other kind of securities.

Mr. MITCHELL. Yes; but I think that it then comes down to the opening wedge argument. If you do it for this one, why don't you do it for that one and why don't you do it for the other.

Chairman PROXMIRE. Governor Mitchell, are you saying that the Federal Reserve Board can't stand up to pressure? If there is any organization that can, any kind of pressure, both good and bad, it is the Federal Reserve Board, without reflecting any——

Mr. MITCHELL. No; I think the Congress has given us all the equipment we need to stand up to pressure, I agree, but I still am saying—you asked me to comment on this——

Chairman PROXMIRE. Yes.

Mr. MITCHELL. I am just telling you what I think the thinking is. That this is the reason that they don't think that we ought to qualify for investment in the portfolio additional varieties of debt.

Chairman PROXMIRE. You see, here is the trouble with the proposal you have here. I agree with Congressman Reuss that it could be helpful. But the difficulty is that you have to have an emergency situation for the savings and loans as compared to the ordinary situation for the commercial banks.

My second point is, you have a different rate. I understood you to say that the rate would be higher for the nonfinancial institutions.

Mr. MITCHELL. That is right.

Chairman PROXMIRE. Third, you would use a conduit which would be a competitor, and often would be a competitor for the savings and loan in Madison, Wis., to have to go to the bank with whom they compete, or in Richland Center, your town, with whom they compete isn't exactly the easiest thing in the world. And isn't in my view necessary.

Furthermore, the Home Loan Bank Board, a competent agency that you have worked with closely, knows these savings and loans. They are in a position to exercise real judgment with regard to them. So why isn't this a far better way of doing it? They could eliminate

the discriminatory rate. They could eliminate the competitive element, and they could do it so much more smoothly and comprehensively as far as the country is concerned, and the effect on housing overall.

Mr. MITCHELL. Well, there isn't any system that is going to enable us all to have our cake and eat it, too, and I think it would be nice if, you know, the reins of monetary policy pulled equally all across the board. But they don't.

I think that trying to make them pull evenly all across the board is perhaps more than can be accomplished, either with a discount mechanism or with the Federal Reserve purchase of this type of security for holding in its portfolio. I believe the Treasury is proposing a scheme now where they have an agency which will put all of the agency issues together. Maybe this is the solution to the problem.

Chairman PROXMIRE. Of course here you have got the reins not pulling at all equally. They are all on the poor old housing horse, yanked tight on him, and everybody else moves ahead. The business horse goes ahead at a terrific rate.

Mr. MITCHELL. Yes. Well, it is not all housing. I think State and local financing took its lumps in 1966, too.

Chairman PROXMIRE. Let me ask you this. I think the questioning by Congressman Reuss on the announcement effects of the discount rate were very helpful, because I think there is no question that this would weaken the announcement effect.

Mr. MITCHELL. Oh, yes; that is right.

Chairman PROXMIRE. I don't know how you can get away from that. However, why not do something like this. I think this is maybe what Congressman Reuss was indicating, and this is hypothetical. You pick your own peg.

Supposing you pegged the discount rate to the bill rate plus, say, 50 basis points. Then when you wanted the announcement effect you just varied from that. Maybe that is what you had in mind when you were answering Congressman Reuss.

Mr. MITCHELL. Not the pegged relationship. As you know, the Canadians had experience with this——

Chairman PROXMIRE. The Canadians did that in 1956.

Mr. MITCHELL (continuing). And they were not satisfied and we were not satisfied from a study of their experience.

Chairman PROXMIRE. In 1956 they had it.

Mr. MITCHELL. Yes; because no matter which rate you choose, there are special reasons for a particular rate to get out of line temporarily with other market rates. So we would not want to peg to any one rate; but I think in line with what Congressman Reuss was saying, there is no great problem involved in occasionally saying we intend announcement effects with a particular action, and in all other cases we don't. I think this would be a rare occasion, but I wouldn't want to preclude it being done.

Chairman PROXMIRE. On page 18 in your report you say, "Justification for Federal Reserve assistance to nonmember institutions must be in terms of the probable impact of failure on the economy's financial structure."

Doesn't this effectively bar direct aid to any but the very largest, most pervasive national institutions, since significant impact on the financial structure of the country at large can scarcely be ascribed to small or parochial institutions, member or nonmember?

Mr. MITCHELL. Well, again it depends. The home loan banks presumably are in the position to take care of the local situations, and it is only when you get these spreading into large regions or into important regions as far as S. & L.'s are concerned, that I think it might get beyond their capacity. Otherwise I think they have their own central bank in a sense, which is prepared to assist them.

Chairman PROXMIRE. I understand, notwithstanding the warnings of the Federal Reserve authorities, that no single measure of ease or tightness is dependable; the fact is that the press and the financial community do read great significance into weekly levels of net borrowed or free reserves.

If the proposals of the report are made effective, how should the significance in reading of this possible measure of ease or tightness be effective?

Mr. MITCHELL. Well, I presume I would have to say that if someone is following net borrowed free reserves as a guide to monetary action, he would have to get his frame of reference adjusted to a changed level of borrowing as a result of these changes.

Chairman PROXMIRE. That should take a heroic effort on your part, since they haven't paid much attention to your assertions in the past that they shouldn't zero in on one or two indexes. I hope we can get this across.

Mr. MITCHELL. Yes. Well, the effort to have some simple characterization of what the Federal Reserve is doing, whether it is money supply or free reserves or "tone and feel" or something else, is going to continue regardless of how inadequate it may be.

Chairman PROXMIRE. Could this have a kind of a demoralizing effect or at least an unfortunate effect on some banks that operate on a marginal basis with inadequate capital now, and because they are able to get access to the discount window more readily, they will be less likely to secure the kind of capital they should have or to reduce their operations to a level consistent with their capital?

Mr. MITCHELL. Well, in the use of the basic borrowing privilege, which is the only thing, you know, that is automatic, if their capital position or the quality of their management or their asset position are deficient, the Federal Reserve bank, in the district in which they are located, would advise them that they couldn't use this basic borrowing privilege.

Chairman PROXMIRE. Isn't there likely to be an overall adjustment to the fact that you have got this extra source of credit when you need it likely in the judgment of the bank management to maximize their profits to say, "We can get away with a little less capital?"

Mr. MITCHELL. I think some bank managements will have less liquidity because they will say, "I have got this here if I need it," but I think on the whole that is good.

I talked to a banker in a relatively small town in the South, and I asked, "What are you going to do if this goes into effect?" He said, "I'm going to be able to increase my loans by about 10 percent because I have had to keep this kind of liquidity cushion in order to protect myself."

Chairman PROXMIRE. So it could have a wholesome effect as far as reducing liquidity requirements; but it might have possibly, or you don't think it would have a very significant effect on adequacies of capital. You can discipline that by just not providing the funds?

20-205—68——5

Mr. MITCHELL. Yes; that is right.

Chairman PROXMIRE. If their capital is not sufficient. I just have one or two brief questions; one other question relates to a question raised by the vice chairman of the committee, Congressman Patman, who wants to know about H.R. 19417.

I have asked you about this in general, but if you could reply with regard to this particular bill.

That bill has as its singular objective allowing institutions insured by the Federal Savings and Loan Insurance Corporation, Federal Credit Union, to make direct use of the discount facilities. He introduced this bill on September 4 of this year and would like your comment on the bill. You have commented in general on the principle of it.

Mr. MITCHELL. Mr. Chairman, he wrote me a letter and asked me if I would comment about this today if I could, and I discussed it with the Board yesterday, and we reached an understanding that we would make an official reply. We are going to study this matter and make an official reply to him, and so I would prefer not to comment on it.

Chairman PROXMIRE. All right.

Well, I think the tenor of the questioning by all three of us this morning has indicated our very deep concern with the housing industry and how this proposal might affect savings and loans, and other institutions indirectly. I think all of us agree that this has a very fine potentiality for the country, and you have indicated very ably some of the ways in which this could improve the banking system.

I want to thank you for your usual competent, responsive testimony.

Mr. MITCHELL. A pleasure to be here, sir.

Chairman PROXMIRE. The committee will reconvene next Tuesday when we will hear three eminent economists' views on this proposal.

Mr. MITCHELL. May I say that I think you have scheduled three very fine economists and it should be a very interesting session.

Chairman PROXMIRE. Thank you.

Mr. MITCHELL. All Federal Reserve alumni, I might add.

(Whereupon, at 11:45 a.m. the committee recessed to reconvene at 10 a.m., Tuesday, September 17, 1968.)

FEDERAL RESERVE DISCOUNT MECHANISM

TUESDAY, SEPTEMBER 17, 1968

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room S-407, the Capitol, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senator Proxmire.

Also present: John R. Stark, executive director; William H. Moore, senior economist; and Douglas C. Frechtling, minority economist.

Chairman PROXMIRE. The committee will come to order.

This is the second day of our consideration of the Report of the Federal Reserve's Committee on the Reappraisal of the Federal Reserve Discount Mechanism. Last week we heard from Gov. George Mitchell, who explained the purpose and System-thinking about the discount window and especially the significance of the discount rate as a monetary tool.

Today we will hear from three gentlemen from the academic field, each of whom has given a great deal of thought to the role of the discount mechanism viewed historically and its place in today's financial organization.

What is the real function of the discounting mechanism in supporting the economy? In a credit crisis, is the assistance of the Federal Reserve to be available only to member banks, with the financial intermediaries—especially the savings and loans and their principal interest; namely, the housing industry—left to the mercies of the market?

Savings and loan institutions, which are dependent upon real savings and in general make long-term commitments, are important to the financial system of the country. I think these hearings have demonstrated (1) that we need to question whether the rediscounting operation is a useful tool of monetary management, and (2) whether the constitutional power to regulate money has properly been placed in an institution with limited contacts with the country's financial requirements.

Our three witnesses, who I hope will help us discuss these matters are Ross M. Robertson, professor of business economics and public policy, Indiana University; Lawrence S. Ritter, professor of finance and chairman of the department of finance, New York University Graduate School of Business Administration, who, I understand, has been delayed by a plane flight, but should be in shortly; and Thomas G. Gies, professor of finance, University of Michigan Graduate School of Business Administration.

I have here an interesting letter from Prof. Milton Friedman, of the University of Chicago. It is a brief letter and because we have had the defense, so to speak, of the new proposal made by Mr. Mitchell, and as I understand you gentlemen are quite favorably disposed, it might be helpful if I read this brief critical letter into the record and you might keep it in mind during the discussion period following your presentations for comment.

This was mailed from Oslo, Norway, September 13, 1968.

"Dear Senator Proxmire:

I understand that the Joint Economic Committee is holding hearings on September 17 about the Federal Reserve System's proposed redesign of its discount mechanism. On the assumption that this is correct, I am taking the liberty of submitting to you some comments for the record since I shall still be in Europe on that date.

"The proposed redesign (as outlined in *Reappraisal of the Federal Reserve Discount Mechanism*," *Report of a System Committee*, July 1968), seems to me a major step backwards.

"It is urgent that, at the least, there be a full congressional investigation by the appropriate congressional committees before the proposed plan is put into effect.

"The present rediscount mechanism is an anachronistic survival of an earlier day. Its initial function was to assure that pressures on any one bank could be relieved before spreading doubt and distrust about other, entirely sound, banks and so causing general monetary difficulties. It was not properly used in the early 1930's for this purpose, with the result that Federal Deposit Insurance was enacted. Such insurance now performs effectively the function discounting was supposed to but did not perform. The difficulties of any one bank do not give depositors of other banks any reason to fear for the safety of their deposits. Hence, since FDIC there have been no serious runs on significant groups of banks. Rediscounting, therefore, has no important remaining function to perform. It only adds a disturbing element to the monetary system that renders the Federal Reserve's major task of monetary control more difficult and erratic. For this reason, I have long favored the essential elimination of rediscounting as a tool of monetary management.

"The Federal Reserve proposals go even farther back—to the disastrous attempts by Secretary of the Treasury Shaw in 1905 and 1906 (if my memory serves me right) to use Treasury balances for precisely the purposes for which the Federal Reserve proposes to use rediscounting—to ease seasonal and exceptional pressures on individual banks or groups of banks. This policy was an important factor in paving the way for the Banking Panic of 1907 by encouraging banks to keep unduly small reserve balances in the expectation—which when the pinch came was disappointed—that the Treasury would bail them out. As I read the Federal Reserve's present report, I could hear echoes of Secretary Shaw's confident pronouncements more than 60 years earlier and the whole analysis was pervaded by the same fallacy that marred his project—the failure to allow for the reflex influence of the existence of the new mechanism on the policy of the banks themselves.

"The Federal Reserve System has ever since its inception had two very different functions: monetary policy—control over the quantity

of money; and banking supervision—regulation, inspection, supervision of member banks. Many of its major mistakes have understandably arisen from this schizophrenic character of its functions. This has fostered the confusion of money with credit; of the interest of its members or the banking community in general with the interests of the public at large.

"It has appeared in recent years that the Federal Reserve has increasingly recognized the difference between these functions and has given its monetary role primacy. Unfortunately, the present proposal is in precisely the opposite direction. It subordinates the major function of the system—promoting a stable monetary framework for the Nation—to the minor function—facilitating the operations of a particular set of business firms, its member banks.

"If the Federal Government is to regulate, supervise, and subsidize commercial banks, it had best be done by an agency that is specifically set up for that purpose and has no responsibility for general monetary policy. Far better to separate out these functions than to let them confuse and conceal the operation of general monetary policy. Yet the Federal Reserve proposals go in precisely the opposite direction.

"Aside from these objections on grounds of broad principle to the Federal Reserve proposals, the specific proposals themselves are highly objectionable. In effect, they consist in passing out sizable subsidies on a highly differential basis to particular groups of banks. The Federal Reserve report does not, of course, describe its proposal in this way, but that is precisely what it is.

"A bank that is enabled to borrow from the Federal Reserve receives a subsidy equal to the amount borrowed times the difference between the interest rate at which it could have borrowed these funds elsewhere and the discount rate. At one point the Federal Reserve report cites $2.5 to $3.8 billion as an estimate of the maximum credit extension under *one component of its proposal* (p. 10 for short-term adjustment credit). If the differential between the rate on other sources of funds and the discount rate were two percentage points—a moderate estimate—this item alone could amount to a subsidy at the rate of $50 to $76 million a year!

"And the total proposal surely could involve a subsidy of several times this sum. The subsidy will be paid by the U.S. taxpayers. It is they who provide the funds to pay the interest on the Government securities held by the Federal Reserve which enables it to lend at rates below market rates.

"It may be desirable to subsidize some or all commercial banks—though I am dubious that it is. Maybe, we are now implicitly or explicitly taxing them too highly and should remit the taxes. These are relevant questions. But it seems to me inconsistent with our basic political values that they should be decided by an administrative body like the Federal Reserve rather than by the elected representatives of the people.

"Major issues of principle and policy are involved in the Federal Reserve proposals. It is urgent that they receive full consideration and public discussion.

"Signed, Milton Friedman, professor of economics, University of Chicago.

[Comments on Professor Friedman's letter, subsequently received from the Board of Governors of the Federal Reserve System appear at the end of these hearings. See p. 79.]

Chairman PROXMIRE. So, with that happy note of difference, I would appreciate it, if you will begin, and Mr. Ritter will join us, I hope shortly.

STATEMENT OF ROSS M. ROBERTSON, PROFESSOR OF BUSINESS ECONOMICS AND PUBLIC POLICY, INDIANA UNIVERSITY

Mr. ROBERTSON. Mr. Chairman, I have been a member of the faculty of Indiana University since 1957; I am presently chairman and professor of business economics and public policy and director of business history studies. Before coming to Indiana University I was financial economist at the Federal Reserve Bank of St. Louis and from 1965 until early this year I was a visiting scholar in the Office of the Comptroller of the Currency. During my tenure in that office, I wrote a book, commissioned by Comptroller James J. Saxon, The Comptroller and Bank Supervision, which, coincidentally, is being officially published today.

I appreciate the opportunity to appear before the committee to testify on Federal Reserve proposals for changes in the discount mechanism. My prepared statement is necessarily brief. If the substance of my comments is of interest to the committee, I will be happy to expand orally and in writing upon this written testimony.

I should like to preface my remarks with a word of congratulation to the System Committee that prepared the report entitled "Reappraisal of the Federal Reserve Discount Mechanism." It is a succinct and straightforward document, couched in unambiguous language and deserving the careful attention of students of money and banking throughout the world. Its supporting research papers, though occasionally inaccurate and repetitious of monetary mythology, do give us a convenient and useful summary of the historic role of the discount mechanism and a statement of conventional economic thought concerning the economic effects of this monetary tool.

In general, I approve the proposals of the report with the reservation, however, that they do not go far enough toward making the discount rate a true money-market rate.

The thrust of the report of the System Committee is in the direction of making the discount window much more readily available to member banks and, under certain conditions—in Federal Reserve jargon—"justifiable circumstances"—to nonmember banks and other financial institutions. In view of the Chairman's comments earlier in this hearing, I will want to expand on the proposals that would make discount ing available to nonmember banks and other financial institutions.

The System Committee has proposed that member banks be given a "basic borrowing privilege" restricted as to both amount and frequency but with far less constraints than those imposed by the present regulation A. The proposals further contemplate that the window be open beyond the basic privilege limits but subject to administrative procedures roughly similar to those in operation in Reserve bank credit departments during the past decade. There is a further provision that special seasonal borrowing privileges should be authorized

for banks subject to pronounced seasonal swings in either loans or deposit withdrawals. Finally, it is proposed that, over and above these three categories of borrowing, the Federal Reserve banks make unequivocal their willingness to extend emergency credit to member banks and as a "lender of last resort" to other financial sectors of the economy through non-member institutions. These proposed changes in the discount function contemplate an increase in the number of banks regarding the window as a source of funds and, presumably, in the dollar volume of discounts and advances to member banks.

At this point we should suppose that the System Committee would go on to recommend that Federal Reserve banks exercise a substantial degree of discount-rate flexibility. But no! Despite the quantity limitations placed on member-bank borrowing and, when necessary, the administrative sanctions that may be invoked, the System Committee is apparently apprehensive about too close a linkage of the discount rate to market rates generally. To be sure, it is anticipated that changes in the discount rate will be more frequent than in the recent past, but it is apparent that Federal Reserve officials do not wish to place reliance on the discount rate as an effective credit-rationing device. Instead, it is anticipated that ". . . the exact relationship to market rates at any time will depend largely on current monetary conditions and policy objectives. . . ." Indeed, the committee feels that ". . . related market rates would move higher relative to the discount rate in periods of restraint and lower relative to the discount rate during periods of ease." I should have thought that the expectation would be the other way around, as indeed it would be if the discount rate were envisioned as a true money-market price.

As I have already remarked, the proposed changes are commendable in that they move toward making the injection of Federal Reserve credit more responsive to signals transmitted from the financial marketplace. The consequence would almost surely be less dependence on week-to-week and day-to-day open market operations, so that the monetary authorities could place less reliance on fallible human judgments about transitory change in financial markets. Moreover, managers of member banks, who control nearly 85 percent of the commercial banking resources of the country, would have greater flexibility in the direction of their institutions and would almost certainly be able to plan more effectively over substantial periods of time. The patent fact remains that the discount departments of the several Reserve banks would still be required to intervene in the private marketplace and the ultimate consequence, I am afraid, would be continued intrusive meddling in the internal affairs of member banks. In fact, the proposals for calculating seasonal borrowing privilege imply that the credit departments of Federal Reserve banks will actually participate in the asset management of some member banks. Decentralization of central-bank intervention and a resulting boost in the importance of the 12 district banks may seem commendable in principle, but I am not sure that the economic consequences of decentralization would be a remarkable improvement over present intervention from Washington and New York.

Why does the Federal Reserve continue to insist upon both quantity and frequency limitations with the ever-present threat of administrative coercion? Why not simply make the discount window freely open

to dues-paying members of the club—that is to say, the member banks—at a rate or structure of rates set so as to deter or encourage member bank borrowing? Why, in short, does the Federal Reserve not depend on markets and prices to help more in the allocation of financial resources?

The answer is, first of all, that bankers in general and central bankers in particular are prone to conservatism when any public policy change is suggested, whereas academicians are inclined to urge change that may seem precipitate to those who shoulder responsibility for public and private financial decisions. But it seems to me further that certain assumptions and prejudgments color the report of the System Committee, as well as most of the supporting papers, and that they should be explicitly articulated and defended by the Federal Reserve.

In the first place, considerable weight is given to Federal Reserve history up to the early 1930's. In my view, System experience before 1933, and perhaps before 1951, should be disregarded in this context. These years spanned another day and time, an economic era long past. I think it is neither unfair nor unkind to say that the Federal Reserve in its early years was run by men who had no real sense of what a central bank is supposed to do. A careful reading of the legislative history of the Federal Reserve Act and detailed attention to Federal Reserve policy actions before 1933 lead to the firm conclusion that during these first two decades stabilization policy as we now conceive it was completely foreign to early Federal Reserve thinking. It was the duty of the central bank, so its founders and early managers believed, to provide liquidity in times of recurring monetary crises, to mitigate seasonal swings in bank reserves, and, more generally, to provide the "right" amount of credit for the economy. The statement of credit objectives were never more explicit than that generalization.

Look as you will, you will find no insistence that the objectives of monetary policy should be the stabilization of incomes or employment or prices or anything else. And the notion that during the 1920's the Federal Reserve was attempting to maintain a stable price level is a myth, pure and simple. You never find an explicit statement of that objective.

Monetary policy of the 1920's was probably more closely attuned to international than to domestic considerations. It is clear in retrospect that Governor Benjamin Strong was continually "playing footsie" with Lord Norman, then Governor of the Bank of England, in an effort to get England solidly back on the gold standard at the old mint par of exchange.

If proof were needed of the total lack of understanding of central bank functions, we have only to analyze the terrible deflation of 1929–33. Federal Reserve authorities callously allowed the economy to grind down to a halt, most of them acting as though the central bank, like the commercial banks perishing throughout the country, could fail.

I do not mean to pass a harsh judgment on our forebears. The ignorance of central bankers in those days was simply a part of the ignorance of economists about macroeconomics, which in 1930 was about at the theoretical level of surgery in the year 1500. The point I wish to make is that any experience with the discount mechanism emerging from those years gives us few insights for today's problems. Specifically, we cannot conclude from the alleged ineffectiveness of progressive

rates or penalty rates as applied in the 1920's that they would be similarly ineffective today. Nor can we infer from an inspection of data on member bank borrowing in the 1920's, as the Federal Reserve papers do, anything about levels of member bank borrowing in the sophisticated financial environment of today.

Let me turn to a second and final consideration. I think it is fair to say that there runs through both the committee report and the supporting materials the notion that we may once again be confronted with serious and even disastrous economic downturn. With each passing summer I am less inclined to pontificate about what modern economics can and cannot do. But of one thing I am certain. Over the past two decades we have gradually worked out procedures for avoiding both serious declines in economic activity and disruptive rates of inflation. We have, in a word, devised the tools for a substantially effective stabilization policy. To be sure, we do not move quickly enough in fiscal policy determination, and I am inclined to think that we rely too much on so-called flexible monetary policy. Nevertheless, the experience of the last 7 years has pretty well shown that the economic system of the United States, with its vast potential for output and growth, need never again suffer the ravages of depression.

In such an environment monetary authorities, like those responsible for the bank supervisory function, can experiment in the direction of removal of regulatory constraints. As I have written a little book that has just been published today, "The Comptroller and Bank Supervision," a copy of which I shall leave for the use of the Joint Economic Committee, in the modern setting of a stabilization policy guaranteed to prevent wide swings in economic activity, venturing in the public interest, like venturing in the private interest, becomes progressively less risky. I respectfully suggest that the Federal Reserve be more venturesome in its redesign of the discount window. Let the central bank experiment with a window that is freely open during business hours—at a posted rate or rates. Let the officers of the credit departments of the several Reserve banks experiment with progressive rates and penalty rates. And let differential rates exist among Federal Reserve districts if the several banks so rule. Let the examination departments of the Reserve banks (and/or national bank examiners) be responsible for scrutiny of the balance sheets of member banks; and if a member bank is increasing its indebtedness beyond limits acceptable to bank supervisory authorities, let these authorities take appropriate action. And let no one be concerned about the power of the Board of Governors to control the total volume of bank reserves, for the Federal Open Market Committee can absorb reserves as it pleases through open market operations. The power to absorb reserves in this way is absolute and unquestionable.

It is my recommendation, in other words, that the discount window be open to member banks on a rate basis purely and simply. I would be astonished to find Professor Friedman in disagreement with such a proposal, which makes the injection of bank reserves dependent upon market decisions and based on a market price rather than upon the arbitrary ruling of the Federal Open Market Committee, which through its directions to the trading desk in the New York Federal Reserve Bank injects reserves sometimes on the basis of whim and almost always on a basis of the "feel" of the market.

20-205—68——6

It is my conviction that the problem of the last third of the 20th century will be too little finance rather than too much, and I am equally persuaded that as a matter of public policy we should increase our reliance on prices and markets for the most effective allocation of all our resources. It is the substance of my testimony that we should give over to private financial institutions a larger role in the determination of appropriate levels of bank reserves and a stronger voice in their geographic distribution. This recommendation is anything but a proposal for a subsidy of member banks, as Professor Friedman suggests. We must remember that member banks are required to keep nonearning assets in the form of legal reserves, presently totaling more than $22 billion, and so incur a cost of being members of the System. And if my recommendation were accepted, the discount rate would in tight-money times ordinarily ride not below but above the general level of short-term market rates. The notion that this is a subsidy is simply incorrect.

I respectfully ask that Federal Reserve authorities give further consideration to these suggestions before instituting changes that, as far as they go, promise improvement in the institutional arrangements of the American financial system.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you very much, Mr. Robertson.

Mr. Ritter, you arrived a little late. Are you prepared to proceed with your statement?

Mr. RITTER. Yes, I am. I apologize for my lateness.

Chairman PROXMIRE. You accommodated us by submitting your paper in advance. I had a chance to read it last night.

Mr. RITTER. The shuttle is not a dependable mode of travel nowadays. You either sit on the ground or circle in the air.

Chairman PROXMIRE. You may proceed.

STATEMENT OF LAWRENCE S. RITTER, PROFESSOR OF FINANCE AND CHAIRMAN OF THE DEPARTMENT OF FINANCE, NEW YORK UNIVERSITY GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

Mr. RITTER. I have not been particularly anguished over the operation of the discount window in the past, so that I look upon the proposals of the Federal Reserve, which are modest, moderate, and very gradual, as being a step in the right direction, although I agree with Professor Robertson that perhaps they do not go far enough.

For example, the proposal does not say anything to speak of about rate adjustments except that they are likely to be more frequent. Most of the proposal deals with the operation of the discount window rather than with the price that will be charged for this facility, and as far as it goes I think it is definitely a step in the right direction.

Discount policy has always been an important part of Federal Reserve policy. At the beginning it was one of the few devices mentioned in the preamble to the Federal Reserve Act; and, indeed, at the beginning it was the only instrument of monetary policy. The Federal Reserve could not change reserve requirements and there was no such thing, no conception, of open-market operations. And so, for a decade or so, discount policy and the discount rate was the main instrument of Federal Reserve policy.

As such, it followed the long tradition of central banking as the lender of last resort, and I still look upon the discount window as performing primarily the function of lender of last resort rather than the function of day-to-day, month-to-month, or cyclical stabilization policy. So that from my point of view, from the point of view of the functioning of a lender of last resort, this proposal moves in the right direction, although perhaps it does not go far enough.

I would not have thought it was too necessary, actually, to say all of this except for the fact that 2 years ago almost to the day, in August and September of 1966, the Federal Reserve, through the methods it used to impose tight money, brought the economy awfully close to the brink of an old-fashioned financial panic, an old-fashioned financial crisis. You might remember that during the year 1966 the Federal Reserve instituted a program of tight money. I am not objecting to that. I am just stating a fact. Market rates rose in response to this, and the banks found themselves as the summer progressed under considerable pressure. Negotiable CD's started to run off at the larger banks and even the smaller banks found their nonnegotiable certificates of deposit disappearing. As a result, the banks found themselves severely squeezed for funds in August of 1966.

Well, that is the kind of situation which the discount window operated by a lender of last resort is supposed to alleviate. That is what the discount window has historically been and that is what we all thought it still was.

But what happened in the summer of 1966 was that on September 1 the Federal Reserve issued a letter which was rather ambiguous in its statements and gave rise to considerable apprehension throughout the banking community that the discount window was closed to banks which did not behave themselves.

The only way you could get a loan was if you behaved yourself in some way; that is, stopped extending too many loans or did not liquidate municipals. It was not quite clear precisely what was meant except that the Federal Reserve was policing the discount window and in a way that it had never done before, at least in any obvious fashion.

The result of this combination of the September 1 letter which warned banks about the availability of discounting and the tight money pressures which had been building up all year came awfully close to bringing about the first financial crisis this country had seen since the 1930's, the early thirties.

Up to that time I would have thought that the Federal Reserve understood clearly that the function of the discount window was more to serve as a lender of last resort in emergency situations than as a shortrun stabilization device. That episode gave me a lot of food for thought as it did many others, and I think the Federal Reserve also started thinking about the implications of the discount window. Within this framework I like what emerged from this study, because the proposal should make very clear that the discount window, although it will still be used for shortrun stabilization purposes, will be more accessible than has been true in the past for lender of last-resort functions.

Finally, I might note that Congress itself could clarify some of the procedures involved in the rediscounting process by passage of

legislation which would remove the eligibility requirements which presently encumber the discount procedure. This is a minor matter, but so is discounting a minor matter, except insofar as it serves the lender of last resort function. Then it becomes a crucial matter.

Mr. Chairman, this, in brief summary, is what is contained in my formal presentation, which in itself, is not very long.

Chairman PROXMIRE. You may read it now, if you wish.

Mr. RITTER. Thank you. I would like to do that.

THE NEW LOOK IN DISCOUNT POLICY

Discount policy has been an integral part of monetary policy in this country ever since the Federal Reserve System was established in 1914. When the Federal Reserve Act was passed by the Congress one of its principal features was the establishment of facilities for rediscounting, facilities which had, up to that time, been non-existent in this country. This innovation in the American financial system was considered so important as to warrant explicit mention in the Act's one-sentence Preamble: "An Act to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

These new facilities for rediscounting, along with other provisions of the Act, were intended to prevent a re-occurrence of the financial crises which had plagued this nation from time to time during the preceding fifty years.

Of course, rediscounting by a central bank was not a new concept. For decades, the Bank of England and other central banks abroad had advanced funds to the money market, and changes in the cost of these funds—the discount rate—had long been recognized as *the* orthodox instrument of monetary policy. Indeed, as far back as 1873, in the first thorough-going exposition of the principles of central banking. Walter Bagehot in *Lombard Street* had forcefully argued that the *main* function of the Bank of England was to serve as a lender of last resort—and that this obligation could only be fulfilled if it rediscounted freely in times of financial stress.

As the ultimate source of liquidity in the financial system, said Bagehot, it is the responsibility of a central bank—when financial strains threaten to become acute—to promptly supply enough liquidity to prevent the economy from stalling for lack of funds.

The wisdom of Bagehot's observations even today, almost a century later, were demonstrated once again only two short years ago during the great credit squeeze of 1966. To briefly recall that episode, in late summer of 1966 the Federal Reserve clamped down firmly and banks as well as their customers and other financial institutions found themselves hard put to acquire funds. Yields on three-month Treasury bills climbed above 5½ per cent and yields on some intermediate-term Treasury bonds rose to over 6 per cent. With market rates that high, banks found themselves unable to roll over maturing negotiable certificates of deposit and their holdings of CDs began to decline. Non-negotiable smaller denomination CDs were also cashed in as households diverted funds away from financial institutions in favor of large-scale direct purchases of high yielding securities. As these sources of funds disappeared, banks anxiously sought money elsewhere. Larger

banks with branches abroad began bidding unusually high rates for Eurodollars, and bidding for Federal funds became similarly aggressive. At times Federal funds were traded at 6 per cent or more, although the discount rate was only 4½ per cent at the time.

On September 1 of 1966 the Board of Governors circulated a letter to each member bank warning one and all that further increases in business loans were not in the public interest, and that the use of Reserve Bank discount facilities for this purpose was not desirable. In addition, member banks were urged not to liquidate municipals or other securities to meet loan demands, since this would put upward pressure on interest rates in other financial markets.

The September 1 letter stated: "The System believes that a greater share of member bank adjustments should take the form of moderation in the rate of expansion of loans, and particularly business loans. Accordingly, this objective will be kept in mind by the Federal Reserve Banks in their extensions of credit to member banks through the discount window. Member banks will be expected to cooperate in the System's efforts to hold down the rate of business loan expansion—apart from normal seasonal needs—and to use the discount facilities of the Reserve Banks in a manner consistent with these efforts.

The September 1st letter of the Board of Governors became a prime topic of conversation in financial circles. Whether or not the Federal Reserve discount window was open or closed became shrouded in mystery. Did the September 1st letter mean that banks were free to borrow at the discount window, or that they weren't?

According to the specific wording of the letter, those banks that held back on extending business loans would find accommodation at the discount window. On the surface, this would seem to imply that rediscounting was freely available to all banks not extending a larger-than-seasonal volume of business loans. In the context in which it was issued, however, it was generally interpreted not as an invitation but as a *warning*, a warning that discount facilities would *not* be available to any bank extending business loans in volume greater than the Federal Reserve discount officer would approve.

In any event, whatever the September 1st letter did actually say, or was meant to say, there is no doubt that it was interpreted as meaning different things by different people. For the most part it was taken as a warning that eligibility for the Federal Reserve's discount facilities was being tightened, that the purpose for which member banks might be extending credit was a criterion subject to close scrutiny and evaluation by Reserve Bank discount officials, and that the discount window would be used as a means of enforcing a type of selective credit control. The letter may have been intended to clarify, but its main result was confusion.

By the choice of means it employed to impose tighter money, the Federal Reserve brought the economy perilously close to the brink of financial panic. There is substantial evidence that in the late summer of 1966 financial markets were dangerously close to an old-fashioned crisis, precisely the type of financial crisis the Federal Reserve had been established to prevent. The continuation of severe reserve pressures, the evaporation of CD money, topped off with what was widely regarded as a threat to close down the discount window to any bank

that did not behave itself, all combined to drain confidence from financial markets in general and from the banking system in particular.

I am not saying that the Federal Reserve should not have imposed tight monetary conditions in 1966. What I am saying is that the means it employed to do so were clumsy and hazardous: closing all avenues to liquidity simultaneously—and threatening to do so is virtually tantamount to actually doing so—is almost sure to create apprehension throughout the financial community and seriously impair the functioning of financial markets. Some safety valves must be left open, and market participants need assurance that they will continue to be left open, to avoid financial strangulation. That is no less true today than it was when Bagehot was writing Lombard Street almost a century ago.

It is for this very reason that the central bank has traditionally been called "the lender of last resort." It is the function of the central bank, surely on a par with any of its other functions, to stand by at all times as the ultimate supplier of liquidity in time of need. Such marginal liquidity may be made more or less costly, by varying the discount rate, but to make it more or less accessible is likely to invite grave repercussions throughout financial markets.

The proposed "New Look" in discount policy indicates that the Federal Reserve has learned a lesson from the 1966 experience. Within the total instrument mix of monetary policy, the discount mechanism is the instrument that is best able to provide a safety valve—to furnish injections of liquidity where needed—when over-all pressures become severe. The System Committee's Report makes it likely that the discount mechanism will perform that function more adequately in the future than it has in the past. Since that should be the primary function of the discount mechanism, within the over-all mix of monetary policy instruments, the Board's proposal is a good one. Its adoption should enhance the effectiveness of monetary policy by making the central bank more responsive to the rapid alleviation of excessive pressure precisely at those points where and at those times when relief is most needed.

The "New Look" will further that end (1) by making member banks less fearful of approaching the discount window, given that the "basic borrowing" line is now more accessible than formerly; (2) by providing that "other adjustment credit" applications are to be expected as more or less a matter of course; and finally, (3) by establishing a category of "emergency credit" which I assume banks will be informed would not have been specified in such detail if the central bank did not expect it to be utilized from time to time. This emergency accommodation will also evidently be available to non-member banks and other financial institutions. If I were to disagree with any aspect of the proposal it would be to question why emergency credit to other than member banks needs to carry a rate "significantly higher" than the prevailing discount rate.

This "New Look" by itself will not by any means guarantee that the discount window will fully serve the lender of last resort function better in the future than it has in the past. It is a step in the right direction, however, and the new discount machinery should facilitate the attainment of that end.

In concluding, it is relevant to note that Congress itself could clarify some of the procedures involved in the discounting process by repealing the eligibility provisions which presently encumber it. For several years the Board of Governors has supported legislation which would broaden the kinds of collateral on which member banks may borrow from the Federal Reserve. At present, and presumably under the new proposal as well, the prevailing discount rate is available only on "eligible" assets. Other paper carries a penalty rate of one-half of one percent above the discount rate. Congress should abolish existing eligibility requirements and permit the Federal Reserve to make advances, without a penalty rate, on the basis of any collateral satisfactory to the Federal Reserve.

Chairman PROXMIRE. Thank you very much, Mr. Ritter.

Our last witness is Mr. Gies. Mr. Gies, you may go right ahead.

STATEMENT OF THOMAS G. GIES, PROFESSOR OF FINANCE, UNIVERSITY OF MICHIGAN GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

Mr. GIES. I appreciate this opportunity to appear before the Joint Economic Committee of the Congress for the purpose of commenting on the Federal Reserve proposals to modify the discount mechanism.

The thoughtful studies conducted by the Federal Reserve System in preparation for the proposed changes in the discount window should be applauded, if only because they reassure us that the willingness to innovate and effect change is present. But at the same time they should be analyzed carefully, for the suggested change are substantive and impinge on the character of monetary policy.

My remarks deal with basic concepts and general relationships, rather than seeking to evaluate what may be matters of essentially administrative detail. The following questions will be dealt with:

1. How would the competitive positions of large and small member banks be affected by the proposed change?
2. How would more liberal access for member banks affect nonmember institutions who are unable to borrow at the discount window?
3. What are the implications of the proposals that the discount rate be changed with far greater frequency in order to keep it closely in line with movements in other money market rates?

I. COMPETITION BETWEEN LARGE MEMBER BANKS AND SMALL MEMBER BANKS

Three observations are important in discussion of this question. The first is the generally accepted proposition that small banks characteristically react more slowly and do not have the management capability of large banks. The competitive gap between the two groups can be widened to the extent that large banks are quicker to recognize borrowing opportunities.

Small banks characteristically operate with greater excess reserve balances than do large banks. The opportunity to borrow on a "no-questions-asked" basis might promote greater use of funds and in turn greater profits to the extent that management capability, loan demand, and investment opportunities allow. However, other things equal, man-

agement capability, loan demand, and investment opportunities are more available among larger than smaller banks. Thus, while both groups might benefit, the relative increase might be greater for large than small banks and thereby intensify rather than close the competitive gap.

The third observation is that an undercurrent of distrust over the new proposals is discernible. Because of this it is possible that the competitive status quo might not change materially. This distrust has been nurtured by two factors: (1) the jaundiced eye given in the past by Fed officials to member bank borrowings, and (2) the explicit but "played-down" objective of trying to gain greater precision in monetary policy.

The first factor has promoted a somewhat "natural" propensity to avoid the discount window. That which has come to be natural with managerial personnel cannot be abruptly changed. This is especially the case when "attitudes" are involved. Although it is appropriate to say that bankers, like all businessmen, should be profit-maximizers and, therefore, relegate any incongruous subjective tendencies to the profit regimen, it is another thing to have this accomplished. Thus, the process of implementation could be long and arduous. It is by no means certain that the reluctance of bankers to borrow from the Fed has significantly diminished over recent years.

The second factor may reinforce the first. It nearly always appears noble to support a cause for the betterment of the "common good." And certainly, trying to gain greater precision in monetary policy can be construed as promoting that common good. Two points, however, diminish the luster of such an objective. For one thing, there is serious concern over the effectiveness of monetary policy and its oft-used open market operations. To then use the discount window as perhaps the primary means of shaping monetary policy, as is intimated, and in turn use open market operations to smooth any subsequent flaws seems inconsistent. If open market operations are not really effective as the major tool, does it not seem questionable to then use it as a refining device?

The second point is the reasonable fear of bankers that their individual credit policies will become more tightly controlled as a result of more direct dependence on the Fed for funds. Banking is one of the more regulated and circumscribed industries. Such independence as remains is highly valued. Further limitation of this independence may be inferred from the proposed greater availability of borrowing.

In summary, if the above conditions prevail it is not likely that the competitive position of small banks will materially improve; rather, it could worsen. Further, nearly everybody thinks in relative terms. Unfortunately, the usual connotation with regard to competition is that "bigger" banks are intrinisically bad, that they distort and disrupt the process of efficient allocation of resources. It only seems natural then, and perhaps patriotic, to nurture the growth of "smaller" banks (for example, via seasonal borrowing privileges) and in so doing hopefully improve their competitive position.

But by aiming to do this through the fundamental character of monetary policy is to imply that the current design of monetary policy is a major contributor in this competitive inequality. Is it in fact? There would probably be few of us here who would say it is. By and

large, we can point to more basic factors (for example, differences in State branching laws). While it is perhaps more practical to seek greater competitive equality as part of the goals of a major change in monetary policy than to seek it, say, through arguing for greater uniformity in State branching laws, the end may not justify the means. Is the marginal value of a gain in competitive equality (which indeed may not turn out to be a gain at all in view of the prior three observations), worth the uncertain result in the effectiveness of monetary policy that such a revamping might bring?

II. Competition Between Member Banks and Nonmember Financial Institutions

In recent years, commercial banks have experienced more rapid deposit growth than nonbank financial intermediaries (NBFI). It would seem then that having an additional source of funds on a "no-question-asked" basis at reasonable rates would unduly expand their present competitive advantage. This could act to the further detriment of the homebuilding industry and its principal sources of funds, savings and loan associations, and mutual savings banks.

One must remember, however, that it was not too long ago that these nonbank financial intermediaries were growing considerably faster and over a much longer period than their bank counterparts. There was a myriad of reasons suggested for this such as low taxes paid by NBFI, their typically lower costs of operation, the nonaggressive solicitation of deposits by commercial banks, et cetera. But now times have changed; among other things, savings institutions pay higher taxes, commercial banks are avid seekers of deposits, and interest rates paid by the banks have more nearly kept pace with the general increase in the level of interest rates than have those of nonbanks. The point is that their relative competitive positions will continue to vary with time and circumstances, thereby making it somewhat dubious to assert that another source of funds is surely needed to enhance banks' competitive position.

For one thing, there is question as to whether commercial banks would increase their use of the discount window appreciably. In addition, the operational and structural problems of the homebuilding industry have become widely known. To the extent that steps are taken to remedy their basic problems—for example, improvement in the secondary mortgage market, broader investment powers, greater improvement in the secondary mortgage market, broader investment powers, greater branching privileges, lower borrowing rates at the Federal Home Loan Bank Board—these NBFI might very well hold their own in the competitive struggle, perhaps even in the face of an extensive increase in the use of the discount window by commercial banks. In short, it might be contended that the present competitive gap argues more for ameliorative steps on behalf of the homebuilding industry than for extension of borrowing privileges for the banking industry.

The suggestion that nonmember institutions be allowed access to Federal Reserve loans through member banks during periods of financial emergency should perhaps be regarded merely as a token gesture. For one thing, the "financial emergency" must apply to a large

number of institutions, and assistance is to be judged in terms of the likely impact of failure on the financial structure of the economy. It appears that the proposal is really talking of conservation of the economy rather than conservation of competition. One might question whether a vigorous competitive relationship between member banks and nonmember financial institutions is assured by the proposed cooperative arrangement for providing a conduit for nonmember borrowing.

However, a more fundamental objection to Federal Reserve lending to nonmember institutions is the simple fact that the effectiveness of monetary actions depends upon limited access of financial institutions to new reserves. Any action which enables savings and loan associations and other nonmember institutions to avoid the discipline of credit restraint undercuts the effectiveness of the monetary authority.

III. Implications of Frequent Changes in the Discount Rate

The primary criticism of the current discount mechanism is its allegedly ambiguous "announcement effects." In principle, changes in the discount rate are generally intended to support and reinforce the effectiveness of open market operations. As such, changes in the discount rate should tend to follow, rather than lead or move in tandem with, movements in market rates. But due to the continuous movements of market rates and the sporadic changes in the discount rate, the relationship varies. It is difficult, if not impossible at times, to ascertain whether the Fed is leading the market and initiating a new phase in monetary policy or following the market and simply adjusting to current conditions.

It is my opinion that announcement effects are important. When clarity prevails, they give official credence to the general movement in market rates and further can be of crucial importance in maintaining or rejuvenating confidence in the dollar. To decrease the ambiguity of announcement effects present in the current discount mechanism, our logic leads to the need for more frequent changes in the discount rate. So, the implications of these changes depend basically on the methodology used.

Numerous methodologies have been proposed, but only two appear to deserve serious consideration. The first involves setting up a planned schedule of changes in the discount rate. The changes themselves would be greater in number and smaller in size than the present mechanism entails, and would allow the discount rate to keep in step with market rates. And upon the need to declare a change in monetary policy, a relatively large change in the discount rate should unequivocally accomplish this.

The second proposal is perhaps more attractive. It involves the concept of a tied rate; that is, the discount rate would be tied to some market rate and then left to vary with that rate automatically. As with the first proposal, a relatively large discretionary change in the discount rate (thereby changing the differential between the rate and its related market rate) should achieve the desired announcement effect. In addition, other advantages could result from this methodology. It is more efficient; there is no need to set up a regular schedule of changes in the discount rate as required by the first method—the market takes

care of this. Also, it provides a nationally determined rate automatically. Further, if we assume a realistic relationship between the discount rate and its market counterpart, the fear of an inordinate increase in the money supply through discounting is lessened. In brief, market forces are allowed to play a greater role in determining the amount of borrowing.

There are problems present, of course, such as what market rate to use, whether the discount rate should be at a "penalty" level relative to market rates, whether nonprice criteria should also be used in determining borrower eligibility, et cetera. We need not discuss these at this time. While important, their detailed treatment now is incidental to the concepts being developed and would be better left for later analysis.

Conclusions

The preceding comments have touched on concepts and basic relationships which I consider important in evaluating the proposed reforms. Based on this, my overall conclusion is that these reforms are not totally acceptable in their present form.

First, they could weaken the competitive position of small member banks. While seasonal borrowing privileges might help their position, the overall resources of large banks could enable the latter to maintain their "share" of the market and probably increase it. This assumes large member banks readjust past propensities to avoid the discount window, and further that they are not thwarted at the discount window in favor of smaller member banks. The feeling among supporters of the reforms is that if the opportunity to borrow at the discount window for member banks is made to be more economically feasible, this tendency for avoidance in the past will fade away, albeit slowly. Further, the limitation of quotas in favor of small banks is obviously an unreasonable form of nonprice bias and, therefore, unacceptable in principle.

A second objection deals with the indirect lending of emergency funds to nonmember financial institutions. The Federal Reserve should make no commitment to support any individual sector of the economy. Perhaps if a particular rate were clearly out of line, the System may be justified in stepping into that market temporarily, but the border between a temporary and a fundamental trend is always hazy. Assistance to one segment of the market sets a precedent for increasing numbers of requests for such assistance.

Again, may I thank you for the privilege of appearing before this committee. I hope these comments may be of some benefit in your final evaluation of the proposed changes.

Chairman Proxmire. Well, gentlemen, thank you very much. These are competent and thoughtful papers and I appreciate the work that you put into them.

Mr. Ritter, you had a chance to glance—unfortunately, you did not have a chance to read in any detail the letter from Mr. Friedman. Just before you came in I read it into the record, so that both Mr. Robertson and Mr. Gies have had a chance to hear it.

I would like to ask each of you gentlemen to comment on it along these lines.

First, how do you answer the Friedman argument that discounting is pretty much an anachronism now, that its purpose has been taken

care of with the—one of its principal purposes, at least, with the establishment of insurance, the Federal Deposit Insurance Corporation and the ending of runs on banks? And, then, what specific public interest functions do the—does the discounting achieve? Now, I am not just talking about what it can do to help banks out of situations in which they find that they need more credit, need more reserves, but I am talking about what impact on the economy, whatever favorable impact on the economy do we get from discounting or do we get from ratifying or approving or encouraging this proposal to broaden discounting, or to go even farther, as you would seem to go, Mr. Robertson, and make it even less inhibited than Mr. Mitchell and the Federal Reserve Board would recommend to us.

Mr. Robertson, would you start out?

Mr. ROBERTSON. The discount mechanism has a long history of at least the two centuries of use in Anglo-American banking, but the fact that a device is old does not necessarily mean that in this day and age it is anachronistic. I feel that the discount window can serve a useful function in enabling banks to adjust reserve positions either because of a sudden outflow of deposits or because of unusual stringencies that develop in the money and capital markets.

As Professor Ritter testified in the late summer and early fall of 1966 we were approaching panic conditions in the money market, and there is no question in my mind that the availability of an open discount window, that is to say, one open on a basis of rate, would have been extremely useful to the financial community in general.

Chairman PROXMIRE. It may have been useful to the financial community in general. Would it have been useful for the economy at a time when the Federal Reserve Board was trying to follow a policy, I presume, of slowing the economy down somewhat, of inhibiting too rapid an expansion, of trying to at that time, at least, although you say earlier even, in the twenties they did not follow a policy of trying to stem inflation, certainly this was the conscious policy of the Federal Reserve in 1966.

If you had had a more active discounting operation, would not this have frustrated the whole purpose of monetary policy?

Mr. ROBERTSON. It would not have frustrated the policy because the Federal Reserve could have met demands for accommodation at the window with higher rates.

Chairman PROXMIRE. Then, it would have really clobbered the housing industry. It was clobbered as it was but then, if you had even higher rates you would have had a situation in which the banks would have been accommodated, big business, the principal customers of banks, would have been accommodated but the housing industry which by and large are not customers of the banks, but of savings and loan institutions, which have no access to the discount window, would have been hit even harder, is that not right?

Mr. ROBERTSON. Senator Proxmire, I would say that the ready availability of funds at some rate is essential at certain points in time. May I also remark that mutual savings banks and savings and loan associations are the customers of commercial banks. They keep deposit accounts with commercial banks, and many of them have substantial credit lines with commercial banks. If funds are available at a rate, the thrift institutions can at least achieve liquidity positions that they

otherwise could not achieve if the commercial banks from which they borrow were unable to obtain accommodation in order to protect their reserve positions.

Chairman PROXMIRE. Yes, but what actually happened in 1966? What happened was that we had a continuous expansion of business. We had inventories going up even into the fourth quarter of 1966 at a very unhealthy rate, a big accumulation, a tremendous expansion of business investment in plants and equipment, and housing just went into a depression. We had housing start dropping to an annual rate of 800,000 a year from an average annual rate of 1½ million.

Mr. ROBERTSON. That is correct.

Chairman PROXMIRE. Under these circumstances, it seems to me if you follow a policy of permitting the banks to borrow, they will take care of their big customers first. It is natural, it is predictable. Of course, they do. I would if I were running a bank.

Mr. ROBERTSON. There is no question, Senator, that the housing industry is peculiarly vulnerable to monetary policy. During my tenure at the Federal Reserve Bank of St. Louis, and for some years after, I made a career of arguing the point of the inequitable impact of increases in rates in general on the housing industry. The reason, of course, is that because of the rise in discounts on federally underwritten mortgages, and subsequently of "acquisition" and other fees on so-called conventionals, borrowers are forced to pay at the outset in the form of increased downpayment, or else builders are forced to add to the price of houses, what is in effect the discounted present value of a portion of their total interest costs on a long-term mortgage. I would be the last person to argue that we should not do something about this particular problem.

I feel, though, that we have in the Federal Home Loan Bank System an institution that is presumably equipped to deal with the problem. It is true that the Federal Home Loan Bank System is bound to what I consider a clumsy and extremely difficult method of raising funds, because it has to go to the marketplace through the issue of so-called Federal Home Loan Bank debentures to raise funds.

Chairman PROXMIRE. And as rates go higher it is harder for the Home Loan Bank Board to go to the marketplace.

Mr. ROBERTSON. That is correct, and I think it is a tenable position that the Federal home loan banks themselves should have access to Federal Reserve bank discount windows. The inequitable pressures on mortgage rates can be mitigated through some such device.

Chairman PROXMIRE. There is a proposal we made on the floor here, the Senate Banking Committee approved it, my amendment, and on the floor it was defeated by a single vote because the Federal Reserve felt this would be the end of the world.

Mr. ROBERTSON. Yes.

Chairman PROXMIRE. The Federal Reserve would have been asked to buy home loan bank obligations when the Board deemed it necessary to help the housing industries, and we limited the amount to $2 billion because at one point Chairman Martin charged it would be $10 to $15 billion, but if the Federal Reserve in the view of Mr. Martin, at least, and one or two other members of the Board should engage in buying Federal Home Loan Board obligations, their feeling was they would no longer be able to function as they did before and the pres-

sures would develop to buy other obligations and he called it a prostitution of monetary policy.

Mr. ROBERTSON. Well, I would say that it is an imaginative and useful application of Federal Reserve bank lending.

Chairman PROXMIRE. I want to emphasize incidentally, what we did was to leave the discretion entirely with the Board as to whether or not in their view there were no other funds available to the home loan bank board or to the housing industry, and that they should only come in when they decided that it was necessary to do so. We were not saying that they were mandating them to come in under any other guidelines. The decision was theirs.

Mr. ROBERTSON. I would suspect that Mr. Gies will disagree with this view, but I feel that there should be a special injection of reserves via the home loan banks to the thrift institutions in order to make more equitable the impact of monetary policy.

Chairman PROXMIRE. And you feel the discipline would come from the higher rates, the higher rates should have a neutral impact as far as housing and business, et cetera, is concerned.

Mr. ROBERTSON. That is correct. Rates will impose a discipline. Let me qualify this remarks with the observation that we should have had an increase in tax rates long before reaching the near-panic conditions of late 1966. In late 1965 we should have reversed the previous tax-rate decrease, the secondary decrease of early 1965, and I think we would have avoided a lot of these problems. I suspect that my colleagues here and in the academic community generally would support this view.

But the point that I wish to stress, Senator, is that if the discount window had been open at a rate, interest costs would not necessarily have gone up further; readily available central-bank credit would have relieved a great deal of apprehension in the security markets, and would have had the effect of preventing the almost frightening rise in rates that occurred in late August and early September of 1966.

Chairman PROXMIRE. Mr. Ritter?

Mr. RITTER. Everywhere I go, Senator, I have to talk about Milton. [Laughter.]

I have been in this business 20 years and 19 of them I have been talking about Friedman.

Chairman PROXMIRE. I am sorry. You know we wanted to get some viewpoints of a reputable economist who has hit hard at this proposal. You gentlemen in general, not entirely, of course, there are some considerable exceptions, do not seem to object to it as vigorously as Mr. Friedman does, so I thought that might be a good way to get into this. If you want to forget him go ahead and address yourself to the argument.

Mr. RITTER. No, no. That would not be playing the game right. I think he may have something in stating that the discount facility is an anachronism. It is quite possible that FDIC now serves the same function that discounting was supposed to serve and that the existing deposit insurance could do the job. But I am not positive of this, and precisely because I am not positive of this I think it would be a shame to abandon a facility such as the discount window.

When the discount window is necessary or when it might be necessary it would be awfully necessary. It would be crucially important.

It seems to me that just because the chances might be great that we no longer will face financial panics of the old sort is not sufficient reason to throw away a mechanism that could be crucially important at times when it is desperately needed. So, I just would not throw it away so quickly.

Chairman PROXMIRE. Why cannot the banks get their funds they need from the Federal Fund Market, the banks that are in really stringent trouble?

Mr. RITTER. Well they can, to a certain extent, although smaller banks have difficulty because of the volume of blocks in which this is traded, but the Federal Fund Market can only trade around existing reserves. It cannot inject totally new reserves into the system.

Chairman PROXMIRE. Yes, but the totally new reserves in the System is an element that the Federal Reserve if they want to have an effective monetary policy might want to avoid.

Mr. RITTER. This really gets down to really the heart of my disagreement with Friedman. I do not think that monetary policy can be that precise. I think it is a rough and ready thing, and it operates within a range of tolerance of accuracy. Friedman thinks it is much more powerful and much more potent and precise than I think it is.

Chairman PROXMIRE. You see, as a Member of Congress and as chairman of this committee, this is very, very frustrating because we look at all of our economic policy instruments. We know how very difficult it is to manipulate fiscal policy, how long it takes to get a tax reduction or a tax increase, and I am one of the obstacles in the way of both. I was opposed to the 1964 tax cut and opposed to the 1968 tax increase because I think it is very disturbing to have to push taxes up and down at the instinct of some economists who are wrong most of the time or at least part of the time.

At any rate, it is hard to do that and, as you all know, it is very hard to manipulate on the basis of the spending side of it, although I think that is probably easier to handle than the tax side.

So, if we do not rely on monetary policy, that means it is very, very hard to have an effective economic policy.

Mr. RITTER. Well, it is hard to have——

Chairman PROXMIRE. And what I am so concerned about with this new device, this new proposal, and one of the reasons we felt it was desirable to have hearings on it and go a little slow on it is because it did seem to somewhat dull and blunt the honing edge of monetary policy. Recognizing monetary policy is not very sharp now as you say, this seemed to make it even less effective. To fade it out even more because it would be possible as all you gentlemen have indicated that the banks would come in for more funds precisely when the Fed is trying to restrain credit and this is the time they would come in and especially use that second measure provided here, the emergency reserve, big banks would do that, at the time when you have a crunch. They would have come in in 1966 and asked for an additional $3 billion. Naturally they would have. This would have made it harder to restrain the economy through monetary policy.

Mr. RITTER. It would, but there is a need for a safety valve. The Federal Reserve cannot pinpoint precisely the degree of pressure it is going to achieve and sometimes it moves a little far and when it moves a little far there has to be some pressure-relieving mechanism. I do

not care what the mechanism is. Through a number of decades the mechanism has been a discount facility, a mechanism to allow the market to obtain a measure of relief at its own initiative so that it does not collapse. And that is the only function that I see for the discount mechanism.

Chairman PROXMIRE. Well, if necessary, they can always back off through open-market operations. If they feel they are not providing——

Mr. RITTER. But open——

Chairman PROXMIRE (continuing). Enough reserves they can buy——

Mr. RITTER. The open market does not hit precisely those areas of greatest need.

Chairman PROXMIRE. Then, we have to improve the operations of our Federal funds market, I should think. If it does not hit that area, then the banks that are in a particular position can be in a position——

Mr. RITTER. I am not that far away from disagreeing with you, but I think the reason is that I do not think it is that important, to begin with. Monetary policy is not that important within a rather broad range, nor is the discount facility that importnat. Nevertheless, it seems to me to be a useful device and, therefore, worth keeping. But if the discount facility were abolished, I would not think that would be the end of the world and if monetary policy acts more or less the way it has in the past two decades, that seems, to me, to be the most we can expect of it.

Chairman PROXMIRE. That is an interesting observation. You say it is not that important to begin with. If you cannot use effective fiscal policy with any rapidity, any speed, within a year or so, if you say monetary policy is not that important, you move to a position where when you are faced with an inflation, you use credit controls, price controls, wage controls.

Mr. RITTER. No. The only policies I would use are monetary and fiscal policies, but it seems to me that for the past 17 years monetary and fiscal policy together have achieved a rather acceptable degree of economic stabilization. They have done pretty well. We have had a pretty high level of employment, and not too inflationary an economy for the past 17 years. They are not perfect but they have done fairly well.

I think the problems of the thirties and the forties were the problems of economic stabilization. But they are not any longer the problems that are the major ones today. There are other problems that are pressing us now. We have solved the economic stabilization problem tolerably well and it seems to me it is time to move on.

Chairman PROXMIRE. Then you do not share the view of the Chairman of the Federal Reserve Board, for example, and of many Members of the Congress, and of many economists who feel that we have a—should have a real concern about the prospects of inflation. Or the view of other economists who feel——

Mr. RITTER. I think it is a matter of concern but we have done fairly well. This year we may have 4½ or 5-percent rate of inflation, which is not good, but over the past 15 years we have done fairly well. Roughly a 2- or 3-percent annual increase in prices.

What I am saying is that it seems to me that we have monetary and fiscal policy fine tuned about as well as we are going to get it, and to try to fine tune it more is not going to give very much of a payoff.

Chairman PROXMIRE. And if we do get a situation where inflation seems to threaten to exceed the limits which you set of 2 or 3 percent, then you feel you are going to have to move in with some kind of controls rather than try and stem it by more vigorous monetary policy.

Mr. RITTER. No. I would stay with monetary and fiscal policy, which is what we have been doing. In recent months it has not worked immediately, but it is very difficult to stem inflation in wartime. I think it is amazing that we are fighting a war—I could stop the sentence there—but to continue it, I think it is amazing we are fighting a war with so little inflation as we have been having.

Chairman PROXMIRE. All the testimony we have had here, though, this is a 4 percent of GNP war. It is not the kind of war we had in Korea as far as the impact on the economy is concerned or the Second World War. It is a terrible and hideous kind of a situation that all of us would like to end as soon as we can but in terms of its impact on the economy, it certainly is of a different kind, not just degree with the war economy impact we have had in the past.

Mr. RITTER. Well, you see, those are the sort of problems that I think are more important today. I think this war has been fought on the backs of the elderly with inflation and on the backs of the kids with the draft and the great bulk of the population has escaped the burden of this war by and large, indeed has benefited from it, and this is a highly inequitable situation, to say the least. I think that the problems of racial polarization, urban reconstruction, and international conflict have replaced the problem of economic stabilization as the main problem, the main economic and social problems facing the country today. We have more or less solved the economic stabilization problem, surely as well as any country has in the world today.

Chairman PROXMIRE. None of them solve it very well.

Before I get to Mr. Gies, I think Mr. Robertson wanted to comment again; is that correct?

Mr. ROBERTSON. I wish to make one remark in response to Mr. Ritter's comment on Professor Friedman's statement. When I handed my testimony to three colleagues to read, each of them returned it with the first comment that I was beginning to sound like Milton Friedman. They meant, of course, that my insistence that we rely on the private marketplace for at least some of our advice about stabilization policy is in the free-wheeling tradition of the Chicago school.

I might add that I do not concur in Professor Ritter's comment that we have fine-tuned public policy as well as we can tune it. We could, for example, do what is commonly advocated by the fraternity of economists and give to the administration authority to raise or lower tax rates across the board by some maximum percentage, say 10 percent, so that we would not have the business of having to go to Congress every time some change in tax rates was made. I for one feel that the very proposal that we are discussing this morning would help us to fine-tune policy. It would leave open market operations as a basic determinant of the level of reserves and would let banks

encountering special problems free to adjust reserve positions without upsetting the securities markets in general.

Chairman PROXMIRE. There are a couple of interesting problems with regard to giving the executive the power to increase or reduce taxes within, say, a limit of 10 percent. One, of course, is that Congress is very sensitive about the argument that the executive has moved in and taken over virtually all the authority and power of our Federal Government now, getting more and more all the time, and Congress is not doing the job it should do. The only real power that Congress has left is the power of the purse, the power to tax and the power to spend. To give that to the executive, what is left?

Another point is that supposing that President Johnson had had the power to increase taxes given to him, say, at the beginning of his election in 1964–65, and he acted on it when he wanted to in the middle of 1966 or——

Mr. ROBERTSON. Early 1966.

Chairman PROXMIRE. Maybe early 1966. He wanted to in a way and then he seemed to back away from it. However, sometime in 1966 or 1967.

Now, we have a situation where many people are saying that we are going to have that surtax for years and that we may need more in taxes.

Mr. ROBERTSON. Well, actually——

Chairman PROXMIRE. So that you ratchet yourself into a position perhaps very quickly where the limits of this are already established but the major problem is this first problem, the problem that Congress feels if we turn this over to the executive, we might as well fold up shop and let him run the whole operation.

Mr. ROBERTSON. No one would be less disposed than I to see Congress give up its control over the basic allocation of governmental resources. But under the present arrangement we have the worst of two worlds. As it happened, the Congress did not agree on the tax increase until this year, and I think that it came at almost precisely the wrong point in time. That is to say, whereas a tax increase could be defended as early as November of 1965, it in fact came just when the economy was showing some signs of flagging; and I am not sure but what the surtax will put too great a damper on the economy in the last quarter of 1968 and the first two quarters of next year.

It does seem to me that to give the executive some flexibility over rates is not to give up the power of the purse. Appropriations and aggregate Federal spending would not thereby be affected, or at least not necessarily affected, unless you take the cynical view that government inevitably tends to spend somewhat more than it takes in, whatever the level of tax moneys, and I do not take that sardonic view of the governmental process.

Chairman PROXMIRE. Mr. Gies?

Mr. GIES. Senator, are we still talking about the discount mechanism?

Chairman PROXMIRE. Yes, we are. I am sorry. It is entirely my fault.

Mr. GIES. I am not sure that Mr. Friedman does not have a point. However, he makes his case very poorly in the letter to you, because his chief complaint is that it is now an apparatus which complicates the making of Federal Reserve policy and incidentally, gives an unjustified subsidy.

Chairman PROXMIRE. Is not No. 1 correct, that it complicates the making of Federal Reserve monetary policy?

Mr. GIES. I do not believe it really is.

Chairman PROXMIRE. Why not?

Mr. GIES. The people at the Federal Reserve would not seem to support that view. None of them if we are to believe the statements that have been prepared for us, feel that their executive skills are tested and seriously complicated by the availabiilty of this.

Chairman PROXMIRE. But what they say is that they can easily compensate for the increase of between $2.5 to $3.8 billion, whatever it is, maybe three at the extreme, they can easily compensate by engaging in open-market operations and the answer, of course, as I indicated here is that one continuous objection to this is that what this does is to push up the rates higher. Even though it is easier for the banks to accommodate to it, it is harder for the savings and loan, which is of some importance. Of greater importance, it is much more difficult for the housing industry to meet this kind of a situation, an industry which is already disadvantaged by our present monetary arrangements.

Mr. GIES. I think he could have made a better point and one which you might have appreciated. That is that the Fed could set the overall funds for availability of credit and the cost of credit via their open-market operation. They have adequate ammunition. It is an adequate instrument to accomplish that.

If in the course of doing this a little imprecision enters, a little uncertainty and variability in the impact of these controls on that part of the institutional apparatus that feels the immediate impact; namely, the commercial banks, then we give them a little leeway via the discount mechanism.

It is similar to the principle that you can drive your car faster if it has a good set of brakes. If you are about to bump an obstacle you can veer away from it, perhaps is a better analogy.

In any case, the discount window is in effect a safety valve. I do not think that this is the only safety valve that the American economy provides. The Federal Funds Market has developed into an extremely effective market. Not only do the large banks have access to it but since I am involved in the management of a number of small banks I can attest to the fact that small banks have ready access to the Federal Funds Market and have been using it. It has depth, it has breadth, it has reasonably good stability.

Friedman, I should think, might have pointed out something else, however, with regard to the discount mechanism. I should think he might have argued for its preservation on grounds of allocation of resources. It seems to me that once you have decided approximately what the overall amount of credit should be and have implemented this through the open-market operation, then one might be concerned to assure the most advantageous use of the funds, the most fruitful investment of capital. Maybe it is housing. Maybe it is plant and equipment. Maybe it is something else. But whatever is the most important use for credit at the margin should not be denied and we can insure perhaps via a penalty system in the discount mechanism at those projects which are able to pay the penalty rate, which means

paying a premium rate for funds, will be fulfilled rather than having been rationed out of the market.

The function that it fulfills, if it fulfills any at all—and certainly historically it does not have the same overriding importance that it did at the time we designed the act—but to the extent that it has a function, I think it has to do with this safety valve, and secondly, the allocation question. And there, I think, maybe it represents a reason justifying the Fed's attempt to reform and preserve it.

Chairman PROXMIRE. I can see you have a different kind of a proposal, in which you might find more merit; but addressing yourselves to this particular proposal, No. 1, the safety valve feature you have just indicated is of considerably less importance because you say there is a fund market available.,

Mr. GIES. There are other ways than the Fed funds market and we can recite them. There are a number of conduits that the market has developed for itself. The Government security market is one.

Chairman PROXMIRE. And No. 2, this would seem to provide a worse rather than a better allocation of resources on the basis of our experience over the last 2 or 3 years, inasmuch as the housing industry has already been hit hard under present arrangements and it would seem that they would be hit harder under this arrangement; because what this arrangement would mean is that the banks would have more funds available but that rates would necessarily have to be higher to compensate for that fact.

Mr. GIES. No. I doubt very much if the price of funds would be higher. But you know——

Chairman PROXMIRE. Of course, they will. If you are going to have $3 billion of additional reserve with the banks you have to compensate, do you not, by buying an additional $3 billion of Federal obligations sold; and that would in effect drive up rates?

Mr. GIES. No. It will have a wash effect. There will be no net change in the price and the availability of credit. It may end up in slightly different hands.

Chairman PROXMIRE. Yes; but there is a very great difference in who gets that credit.

Mr. GIES. Yes, indeed, there is; but——

Chairman PROXMIRE. And it would not be housing. It would be business.

Mr. GIES. Not necessarily. That is not necessarily true.

Chairman PROXMIRE. That was the experience in the sixties, the experience in 1966.

Mr. GIES. I will tell you what the problem in 1966 was. It is very simple and I do not think anyone has really spelled it out; but it is so simple that we should not overlook it.

The housing market can pay as high a rate and the savings and loans institutions can afford to pay as high a rate as anybody in the whole credit market. You have just got to understand that. It is not level of rates that is going to drive me out of the market when I want a mortgage. I can pay the rate. I can pay just as high a rate as anybody else and the savings and loan association which is going to provide me with a mortgage market is capable of operating as an effective conduit when rates of mortgage are 15 percent as well as when they are 4 percent. We do not have to worry about the level

of the rates. It is the sharp, rapid changes in level of rates. This is what hurts.

Chairman PROXMIRE. It is the rapidity of the rise?

Mr. GIES. That is all that it is.

Now, to take care of that point, what should we do? I think we have got to make it absolutely clear to the managers of the savings and loan industry that they are not guaranteed a profit in every single quarter in which they are operating. This is what they have come to believe for 20 some years, that they are supposed to make a profit every year, that the market is supposed to guarantee the investments they have made in the past will continue to yield them a favorable difference between the rate they pay for savings and the rate they get on mortgages.

The reason they have capital in their organization, the reason they have reserves, is to meet those occasions when they are not making a profit and when they are going to run at a loss. This is what everybody else in the market does. This is basically a matter of private management and the savings and loan people have not been forced to confront that fact. I think Congress would be making a vast mistake if they offered them a new shelter so that they could continue to feel that they are never going to feel the abrasive effects of changes in price.

Chairman PROXMIRE. New shelter. But what do they do—they had the funds so that they can turn around and loan to the housing industry.

Mr. GIES. Let it bid for the funds. It means they are going to take a licking if they are going to pay 7 percent on the share accounts whereas the mortgage portfolio is 5 or 6 percent.

Chairman PROXMIRE. On faith.

Mr. GIES. Just what the rest of us work on, faith. We know in the long run we will make out in this economy. This is a magnificent economy for any kind of private business.

Chairman PROXMIRE. But the banks are in a much stronger position. In the first place, they can sell their Treasury obligations which the savings and loans do not have.

Mr. GIES. Not so.

Chairman PROXMIRE. In the second place, they are in a much stronger position as far as the CD's. In the third place, they have got Eurodollars, and in the fourth place, they are going to get access to the discount window on a bigger and broader basis.

Mr. GIES. All those things are fine, but the real thing is whether there is equity capital in the savings and loan rate which permits them to ride through an unfavorable period and the answer is simply take a look at the numbers. They have 6- to 7-percent-ratio capital to deposits like banks.

Chairman PROXMIRE. They have been losing ground to banks in the last 10 years.

Mr. GIES. Last three or four. In the last 20 they have made out beautifully and they have grown and prospered and so have the banks, and to the extent that the savings and loan people and bankers have not done as well as, say, the auto industry, I think this is not because there was not opportunity. I think it is apathetic management on the part of both these institutions. There are very few bankers around. Many more banks than there are bankers. There are many

more savings and loan associations than there are savings and loan managers, I mean people who really manage.

Chairman PROXMIRE. Yes, but this is—it sounds great and it is a fine——

Mr. GIES. I live in this industry.

Chairman PROXMIRE. It is an idealistic notion. It would be great if we had fine managers in our savings and loan. We do have very fine people. People I have met at savings and loan impressed me very much. But you say if they had the right ideas as far as risk is concerned, as far as borrowing, moving ahead, if they had the kind of faith in this wonderful economy of ours, and so forth, then we would not have any problem. The fact is you do not have Professor Gieses operating all our savings and loans. You just have people who have a good amount of ability and competence and judgment, but not outstanding geniuses and you are going to continue to have that in the next few years.

If we adopt our policies on the notion that we just ought to have better management even though we know we are not going to have it, it seems to me, we are going to continue to have our problem with the housing in the future, are just not going to get housing built, and this seems in my view and members of this committee and Congress and many economists, to be a principal economic problem we have facing us. We have misallocated our resources, pushed more into business investment and plant and equipment than perhaps we should have. I think we may well be overcapitalized although that is subject to debate, but we certainly have pushed too little into the housing area.

Your answer is, well, that is because we just do not have people with the right kind of attitude, right kind of training, right kind of understanding in the savings and loan. What do you do about it?

Mr. GIES. You are making a value judgment when you say we have not put enough resources into housing during the last 20 years. We put a rather impressive amount into housing.

Chairman PROXMIRE. Oh, now, come on.

Mr. GIES. Consider the most rapidly growing area of credit over the last 20 years. I think that I am correct, Ross, am I not, that housing—that mortgage credit has grown more rapidly than any other major form of credit? Is that right?

Mr. ROBERTSON. Yes.

Chairman PROXMIRE. I do not know whether it has grown rapidly or not. Is it not the level of housing starts we should have in view of our family formations? We certainly do not have housing for low-income, middle-income people.

Mr. GIES. That becomes a value——

Chairman PROXMIRE. Upper-income people are doing very well.

Mr. GIES. I cannot refute it because I am not capable of making better value judgments than you are but if you ask me if the mechanism is right I can say "Yes, the mechanism is right," and I am not sure you will improve the mechanism by sheltering it from the variations that the market imposes upon it. I think it is capable of surviving without the strong arm of the Federal Reserve.

Chairman PROXMIRE. Shelter-skelter. Here we have—you call it sheltering when savings and loans would go to the discount window but you call it vigorous competition and wholesome when you have the

banks go to the discount window with a greater opportunity. Now, why is that?

Mr. GIES. I am not——

Chairman PROXMIRE. Why do you not have better competition if you have them both go? Mr. Robertson suggested that there might be a way in which you do not send them to the window necessarily but there be a way for the Federal Reserve to provide funds to the housing industry through the Home Loan Bank Board.

Mr. GIES. I am not sure I can give you a good answer by saying one industry, commercial banks, should have access to the Federal Reserve discount window and no one else but the justification that is usually given, and it is the only one I can offer, is that banks feel the immediate and direct impact of monetary policy because they are the— they are subject to a Federal Reserve reserve requirement and no one else is. Hence, it is justifiable that if we are going to push them against the legal reserve requirement wall from time to time, that we should give them a little bit of extra maneuvering room.

I have also already said, but I will repeat, that there are other private conduits for accomplishing this.

Chairman PROXMIRE. Do any of you other gentlemen—yes, Mr. Ritter.

Mr. RITTER. Mr. Chairman, I hope, by the way, when I made my statement verbally, I changed it considerably from my prepared statement, so I hope the prepared statement will go in as read.

Chairman PROXMIRE. I should have made that clear. I appreciate very much your very good summary of your prepared statement. Your statement without objection, will be printed in full in the record as read.

Mr .RITTER. Thank you. I wanted to again mention that in my statement I agree with you. I state there that if there is any part of this porposal that I do not like, it is the sharp differentiation between member banks and other financial institutions in periods of financial crisis, and I do not understand—and no justification is given in the Federal Reserve's Report—why other than member banks would be able to borrow but only at a significantly higher rate.

Chairman PROXMIRE. Right.

Mr. RITTER. I might say, by the way, that this might solve itself over time because it appears as though all financial institutions are moving closer and closer together, that savings banks and savings and loans are becoming more like each other and both of them are becoming more like commercial banks.

Chairman PROXMIRE. Do not S. & L.'s have to go to the bank hat in hand, the banks often their competitors, particularly in a smaller town? Maybe in the big city it might not be quite the same relationship but they are both competing hard for savings.

Mr. RITTER. They are, but my point——

Chairman PROXMIRE. If savings and loans need the additional funds so they can get them from their friendly bank, they are not exactly the customer that the bank is going to take care of first when they have got an important manufacturing firm which is their regular customer that needs the money, wants to expand. What choice are they going to make?

Mr. RITTER. My point is that commercial banks and other financial institutions are becoming more and more alike and 10 or 20 years from now it may be very difficult to distinguish between these different kinds of financial institutions. Gradually by a process of evolution they may all be going to the discount window because they are all more or less banks. This sharp distinction which, by the way, does not exist in the public's mind any more between banks and S. & L.'s, only exists in the minds of academicians and in some legal provisions, this sharp distinction will disappear.

Chairman PROXMIRE. In the meanwhile, however, in the long run we are all dead.

Mr. RITTER. A lot of us in the short run, too, but aside from that I think that while we are here we should look at mechanisms which would permit nonbank financial institutions to utilize the discount window at comparable rates, not at significantly higher rates.

Chairman PROXMIRE. Very good.

Mr. Robertson?

Mr. ROBERTSON. I concur in Professor Ritter's view that financial institutions are becoming more and more homogenous, but I should like to stress the fact that only commercial banks participate in the money-creating process.

Now, it is conceivable that savings and loan associations and mutual savings banks will ultimately become a part of the payments mechanism, that they will be able to receive demand deposits and that checks may be drawn on them, but until that time is reached thev are both the competitors, as you suggest, and the customers of commercial banks.

Under present arrangements, though, mutual savings banks and savings and loan associations have not retrogressed in the past 6 or 7 years. They have maintained their proportionate shares of the market, whether you measure it on the liability or on the asset side. And I think we should remind ourselves, as Mr. Gies has suggested, that they are not falling behind in the competition. They have competed very well this past 6 or 7 years.

Chairman PROXMIRE. I should have the figures available to me. I remember when we discussed this on the floor, as I recall, the savings and loans were doing quite well up until just a very few years ago, but what I have seen lately is that the savings have gone much more heavily to the banks and that they seem to be moving well ahead of the S. & L.'s now.

Mr. ROBERTSON. Well, sir, the proportion of liabilities——

Chairman PROXMIRE. Time deposits. The figures that Mr. McLean of the banking staff gives me, that is in 1963, savings and loans had 39 percent; 1968, 19 percent. That is the new flow of savings.

Mr. ROBERTSON. I would be glad to furnish the committee these data, because it is hard to recall all the figures from memory. If you add up the liabilities or the assets of the six main financial intermediaries—commercial banks, savings and loans, mutual savings banks, credit unions, noninsured pension funds, and life insurance companies—you will find that the proportion of total liabilities or assets held by the savings and loans and mutual savings banks has remained about constant for the past 4 years. It varies by a few tenths percentage point. Savings and loan associations have not retrogressed

in recent years, and neither have the mutual savings banks. They have just not had the tremendous advantage they used to have, when regulation Q in the period from the end of World War II until January 1957, kept the commercial banks from competing for time deposits on a rate basis.

Chairman PROXMIRE. I would like to get that very much. As I understand, the figures I gave just relate to the time deposits of the banks, savings and loan, and the savings—mutual savings banks.

(The following tables were subsequently supplied by Mr. Robertson:)

TABLE I.—TOTAL ASSETS OF MAJOR FINANCIAL INSTITUTIONS

[In millions of dollars]

End of year	Commercial banks	Life insurance companies	Savings and loan associations	Mutual savings banks	Self-insured private pension funds	Credit unions	Total
1956	217,460	96,011	42,875	33,381	18,933	3,271	411,931
1957	222,696	101,309	48,138	35,215	22,027	3,813	433,198
1958	238,651	107,580	55,139	37,784	25,283	4,346	468,783
1959	244,686	113,650	63,530	38,945	29,052	5,024	494,887
1960	257,552	119,576	71,476	40,571	33,135	5,653	527,963
1961	278,561	126,816	82,135	42,829	37,512	6,383	574,236
1962	297,116	133,291	93,729	46,121	41,890	7,186	619,333
1963	312,773	141,121	107,559	49,702	46,554	8,131	665,840
1964	346,921	149,470	119,355	54,238	51,912	9,359	731,255
1965	377,264	158,884	129,442	58,232	58,087	10,468	792,377
1966	[1] 397,620	[1] 166,942	[1] 133,860	60,982	64,468	11,607	835,479

[1] Preliminary.

Sources: Federal Reserve Bulletins and Banking and Monetary Statistics; 1967 Life Insurance Fact Book; Savings and Home Financing Source Book; 1967 Savings and Loan Fact Book; F.D.I.C. Assets, Liabilities and Capital Accounts of Commercial and Mutual Savings Banks; Securities and Exchange Commission Statistical Series, release of July 24, 1967, 1967 International Credit Union Yearbook.

Also various annual reports, Comptroller of the Currency; Goldsmith, Raymond W., A Study of Savings in the United States; Survey of Current Business, various issues.

TABLE II.—TOTAL ASSETS OF MAJOR FINANCIAL INSTITUTIONS

[Percentage distribution]

End of year	Commercial banks	Life insurance companies	Savings and loan associations	Mutual savings banks	Self-insured private pension funds	Credit unions	Total
1956	52.8	23.3	10.4	8.1	4.6	0.8	100
1957	51.4	23.4	11.1	8.1	5.1	.9	100
1958	50.9	22.9	11.8	8.1	5.4	.9	100
1959	49.4	23.0	12.9	7.9	5.9	1.0	100
1960	48.8	22.6	13.5	7.7	6.3	1.1	100
1961	48.5	22.1	14.3	7.4	6.5	1.1	100
1962	48.0	21.5	15.1	7.4	6.8	1.2	100
1963	47.0	21.2	16.1	7.5	7.0	1.2	100
1964	47.4	20.4	16.3	7.4	7.1	1.3	100
1965	47.6	20.0	16.3	7.4	7.4	1.3	100
1966	47.6	20.0	16.0	7.3	7.7	1.4	100

Source: Computed from data in table I.

TABLE III.—PRINCIPAL LIABILITIES OF (CLAIMS AGAINST) MAJOR FINANCIAL INSTITUTIONS

[In millions of dollars]

End of year	Commercial banks			Life insurance companies' policy reserves less policy loans	Savings and loan associations' share accounts, savings capital	Mutual savings banks' total deposits	Self-insured private pension funds' total contributions	Credit unions' shares and deposits	Total
	Demand deposits (adjusted)	Time deposits	Total deposits						
1956	111,391	50,577	161,968	76,219	37,148	30,026	18,933	2,914	327,308
1957	110,254	56,139	166,393	80,206	41,912	31,683	22,027	3,382	345,603
1958	115,507	63,166	178,673	84,416	47,976	34,031	25,283	3,870	374,249
1959	115,402	65,884	181,286	89,357	54,583	34,997	29,052	4,436	393,711
1960	115,102	71,380	186,482	93,242	62,142	36,343	33,135	4,975	416,319
1961	120,525	82,145	202,670	97,552	70,885	38,277	37,512	5,636	452,532
1962	122,258	97,440	219,698	102,150	80,236	41,336	41,890	6,331	491,641
1963	124,636	110,794	235,430	107,746	91,308	44,606	46,554	7,166	532,810
1964	132,258	126,447	258,705	113,558	101,887	48,849	51,912	8,217	583,128
1965	138,315	146,433	284,748	119,942	110,271	52,443	58,087	9,220	634,711
1966	139,310	158,568	297,878	125,410	113,896	55,006	64,468	10,071	666,729

Sources: Banking and Monetary Statistics, and Federal Reserve Bulletins; 1967 Life Insurance Fact Book; 1967 Savings and Loan Fact Book; Securities and Exchange Commission Statistical Series, release of July 24, 1967, and telephone conversations with SEC; 1967 International Credit Union Yearbook. Also various annual reports, Comptroller of the Currency; Goldsmith, Raymond W., A Study of Savings in the United States; Survey of Current Business, various issues.

TABLE IV.—PRINCIPAL LIABILITIES OF (CLAIMS AGAINST) MAJOR FINANCIAL INSTITUTIONS

[Percentage distribution]

End of year	Commercial banks			Life insurance companies' policy reserves less policy loans	Savings and loan associations' share accounts	Mutual savings banks' total deposits	Self-insured private pension funds' total contributions	Credit unions' shares and deposits	Total
	Demand deposits (adjusted)	Time deposits	Total deposits						
1956	34.0	15.5	49.5	23.3	11.4	9.2	5.8	0.9	100
1957	31.9	16.2	48.1	23.2	12.1	9.2	6.4	1.0	100
1958	30.9	16.9	47.7	22.6	12.9	9.1	6.7	1.0	100
1959	29.3	16.7	46.0	22.7	13.9	8.9	7.4	1.1	100
1960	27.6	17.1	44.8	22.4	14.9	8.7	8.0	1.2	100
1961	26.6	18.2	44.8	21.6	15.7	8.5	8.3	1.2	100
1962	24.9	19.8	44.7	20.8	16.3	8.4	8.5	1.3	100
1963	23.4	20.8	44.2	20.2	17.1	8.4	8.7	1.3	100
1964	22.7	21.7	44.4	19.5	17.5	8.4	8.9	1.4	100
1965	21.8	23.1	44.9	18.9	17.5	8.3	9.2	1.4	100
1966	20.9	23.8	44.7	18.8	17.1	8.3	9.6	1.5	100

Source: Data obtained from table III.

Mr. ROBERTSON. It is true that the rate of growth of commercial bank time deposits has increased remarkably in the past decade. The rate of growth of time deposits of commercial banks was 4 percent from 1948 to 1957. From 1957 to 1963, before the recent substantial increases in permissible rates, it was 12 percent. In other words, just a half of 1 percent increase in the permissible rate that banks could pay on time deposits made them much more competitive, but the change only pushed the commercial banks strongly into the competition, and it did not bring about retrogression of the savings and loans and the mutual savings banks.

I am concerned to see these institutions thriving and viable. But freeing up the discount window, and so making credit available to commercial banks on their own initiative, would be as helpful to the construction industry and to the nonbank intermediaries as it would be to any other type of business firm. This credit could just as well flow into particular geographic areas, or at strategic points in time to the housing industry, as it could to, say, the automobile industry. In fact, nonbank intermediaries would themselves be much more flexible with respect to their financial management if they could confidentially rely on commercial banks for accommodation when they need it, though I would advocate other structural changes that would be more effective in the long term.

I do think, Senator Proxmire, that this committee should not forget that any device for injecting liquidity when it is needed will help the whole of the economy and will not be selective with respect to manufacturing industry or to retailing firms.

Chairman PROXMIRE. Well, I think that you may be right in the future or I may be right, I do not know. I just say on the basis of the experience we have had in 1966 and since then, it would seem that because S. & L.'s provide the funds directly to housing and almost exclusively to housing, because the banks have other customers that in the past have taken precedence, it would seem if we provide greater credit for the banks and no access to the S. & L.'s except at a higher rate and except on very rare occasions you are going to have a situation that may well worsen that situation.

I would like to ask you gentlemen to comment on two other matters that we have not touched on and that we should. Mr. Gies mentioned it briefly in his statement. I think they are both important.

One is the announcement effect of this new system. Obviously, if you have the discount rate varying often, you are going to get a disappearance of the announcement impact which might be a good thing, might be a bad thing.

I recall the effect it had on the administration and apparently on the whole country as well as the financial community in December of 1965, when the Federal Reserve Board announced an increase in the discount rate.

Now, with this method they could follow a policy, as I understand it, of having their traditional change in discount rate follow Treasury bill rate with, say, a 50-basis-point difference, then when they wanted an announcement impact they could vary that and make it 100 points or some lesser amount, but in any rate they could do it in a way that would make it clear that this was for the purpose of monetary policy rather than for the purpose of just simply following the market.

Do you think this is a practical approach or do you feel that the announcement effect is something we have to be concerned about, the loss of its impact?

Mr. GIES. I do not know that there are not other ways for the Federal Reserve to express itself to the market in an open-mouth sense of the word. This is in effect what we are saying they do when they employ the discount mechanism. The announcement effect is clearly just that. It is a psychological operation. I would think that the proposed modification would work perfectly successfully if you changed the differential by a substantial amount such as the sort that you speak of from a 50-basis-point difference to a 100-, 200-basis-point difference, whatever you wish to have, you surely could get the message across. However, I am not sure it is the only way. I see no reason why you could not speak to the financial community directly in terms of how you as the Board of Governors view business and credit developments and what you feel is an appropriate kind of offsetting measure for the Fed to take. I do not think the Fed has to livit its open-mouth operation to speaking through the discount window.

Chairman PROXMIRE. Mr. Ritter, would you like to comment?

Mr. RITTER. We have heard a lot about messages lately. You know, the medium is the message, we have been told. And in this case the medium of the discount rate often gives a very garbled message. Usually we do not know what it means. We do not know whether the Federal Reserve is deliberately instituting a change in policy or whether the Federal Reserve, when the discount rate changes, is just following the market along and relatively passively continuing a policy it instituted previously.

It is a very bad way to give a statement to the public as to your intentions.

Chairman PROXMIRE. This might give us an opportunity for improving that, then.

Mr. RITTER. Yes. A lot of people are disturbed about the announcement effect because it is not easy to interpret what the announcement is. So that perhaps some refinement in this could be utilized with this new mechanism.

I do not understand really why the Federal Reserve is always so wary of simply stating what it believes—what it thinks it is going to do. The English language is much more efficient as a transmitter of ideas than changing a discount rate.

Chairman PROXMIRE. Well, that is true, but you know, words have a way of slipping away from you, too. Do they really mean it? What do they mean when they say they are going to follow a policy—I do not know how they put it—of tighter money or of more restraint, and so forth? When they raise the discount rate it is a concrete specific act that may have a little more value than language.

Mr. RITTER. Perhaps they could do both simultaneously and use language along with the discount movement.

Chairman PROXMIRE. Mr. Robertson?

Mr. ROBERTSON. Under my proposal the discount rate could change daily. It might remain constant for 2 or 3 days on end, or it might move several basis points within the same time period.

Chairman PROXMIRE. That would be no announcement effect.

Mr. ROBERTSON. No announcement effect. Announcement effect can be catastrophic. I recall the change in the discount rate in mid-November of 1957, following an *increase* in the discount rate in the previous August. This change in November of 1957 brought about a precipitous drop in rates in general—that is, a rapid run up in bond prices—because it signified to the whole financial community that the Fed was moving toward a rapid easing of monetary policy.

Or take the very slight decrease in the discount rate at the Minneapolis Reserve Bank just a few weeks ago. At the beginning of that week, following 6 weeks of rising bond prices, everyone felt that the Fed was easing money. During the week, rumor had it that Federal Reserve was going to stop easing monetary conditions, and I am sure the announcement—as I recall on a Thursday or Friday—of this slight decrease in the discount rate was meant to allay those rumors, and it did.

Now, I concur with Professor Ritter that there ought to be a better way of communicating than by these subtle, and to many people, sinister devices.

Chairman PROXMIRE. Well, sometimes, of course, I think that is what you are saying, that the Federal Reserve when it varies the discount rate has no intention of giving an announcement effect but they feel they have to follow the market. They do not want the discount rate way out of line with the market. Sometimes they do want to have an effect. You think this would get them away from locking themselves into a situation that is ambiguous, into a situation in which they can be clear about what they are going to do?

Mr. ROBERTSON. It is fluid and completely flexible, if we have a discount rate posted each day.

Chairman PROXMIRE. Then, if they wanted an announcement effect they could simply change the fundamental basis for it.

Mr. ROBERTSON. I would like to remove the announcement effect. The discount rate should move on a day-to-day basis with other rates, much as the Federal funds rate does. If Federal Reserve posts a somewhat higher rate, a rate 10 basis points higher, let us say, on one day than on the day before, it should not expect an announcement effect.

Chairman PROXMIRE. I would like to ask you gentlemen finally to comment, if you would—as I recall there was a Friedman assertion—perhaps I am confused. I thought it was—on the argument that this might constitute a subsidy of several tens of millions of dollars to the Federal Reserve System. I mean, to the banks if this would go into effect, that the taxpayer would be asked to unnecessarily subsidize the commercial banks. If this is right, is it significant? If this is wrong, why is it wrong?

Let us start again with Mr. Gies and go from right to left.

Mr. GIES. I am not sure that I can offer a particularly telling criticism of it. It seemed a trivial complaint considering he had much better grounds for objecting to the discount mechanism. The fact that you happen to offer a subsidy to one particular industry is not a very serious indictment and the amount of the subsidy that he is speaking of, $60 to $70 million, if in effect it is that much it is trivial compared to any number in bank profits. It would not have any visible effect on bank profits and surely not on the attractiveness of new capital going into banking.

Chairman PROXMIRE. I can tell you that to my constituents that is probably the strongest argument against it and I think the constituents of most Members of Congress: $60 to $70 million is a lot easier to understand than $60 to $70 billion.

Mr. GIES. That is an unfortunate problem, though.

Chairman PROXMIRE. And it is a lot of money.

Mr. GIES. Well, it depends on what the tradeoff is, I suppose, and if you can have a total mechanism which satisfied you as a monetary apparatus, that would serve the economy favorably, you would say the price of $60 to $70 million is trivial. We are certainly willing to afford that. We would not be willing to deny ourselves a good apparatus if it only cost $60 to $70 million. I do not think that is the objection.

It seems to me to even raise it is to sort of kick dust in the air and obscure the more important part of this whole issue. So while politically it has interest because $60 million is sort of a big number to a guy whose income is $10,000——

Chairman PROXMIRE. Well, now, I just do not know if you kick it away that much. I wonder if the Fed has shown that the benefits of this system are worth $60 to $70 million. We debated at great length on the Teacher Corps which I happen to think is a highly valuable instrument of improving education in areas where people are getting an inadequate education for a number of reasons now. We will debate $60 to $70 million 3 or 4 days in the Congress and it can make a great difference in a very vital program. So, if the Federal Reserve is not making any showing whether this is really going to improve monetary policy, and the economists seem to be divided on it, I wonder if we can simply say $60 or $70 million is not important. We can forget about that, let us go to the other questions.

Mr. GIES. But on the other hand, if the Fed could satify us that it even gave a small amount of improvement, a 1-percent improvement in the effectiveness of monetary policy, then we are talking about something that would cause the economy to gain perhaps a billion dollars a year in annual growth or to avoid a billion dollar decline in the level of output. To obtain a billion dollar gain at a price of $60 or $70 million is a very worthwhile investment.

Chairman PROXMIRE. Friedman's point is that this is a retrogression in monetary policy. This inhibits it, handicaps it, makes it less sharp. Makes its timing duller, slows it down, and, therefore, to spend $60 or $70 million is an added argument against it.

Mr. GIES. That is right, but it is a trivial addition. I would say in terms of his conclusion I would not feel terribly bad if we give up the discount message but they are surely not arguments that would persuade anyone.

Chairman PROXMIRE. Mr. Robertson?

Mr. ROBERTSON. I simply deny the possibility of a subsidy, and I think perhaps it is better for me to state my strong position on that matter and let my temperate friend to my left, Professor Ritter, modify the statement.

In the first place, it is simply a wrong calculation. We base the calculation on an erroneous assumption if we put it that member banks will be able to borrow at lower rates from the Reserve banks than they can borrow in the market generally. It may very well be that they will have to borrow at higher rates than the market; indeed

if the discount window is run properly, rates will as often be higher than alternative short-term rates as lower.

Chairman PROXMIRE. Why in the world would they borrow from the discount window if they have to pay a higher rate?

Mr. ROBERTSON. Because this is the function of the window. The central bank is the lender of last resort.

Chairman PROXMIRE. They only borrow at discount at the window if you get a lower rate.

Mr. ROBERTSON. Or perhaps as an alternative to selling off securities yielding rates higher than the discount rate. For convenience it is often useful to member banks to go to the window and obtain temporary accommodation quickly, speedily, for a specific purpose, even though they could run off securities and save interest by so doing.

The second point is that the members of the Federal Reserve System are required to keep reserves in substantial amounts. These assets earn nothing, and it is improper, it seems to me, to say that a group is being subsidized when a part of the social cost of running the financial system is borne by these institutions through the maintenance of nonearning assets for social purposes.

Chairman PROXMIRE. I could give you an argument but at this late hour I will not.

Mr. Ritter?

Mr. RITTER. They must also buy stock in the Federal Reserve System. What interest do they get on that now?

Mr. ROBERTSON. Six percent.

Mr. RITTER. Which you might look at as perhaps a reverse subsidy.

Mr. RITTER. I think Professor Robertson is quite right, that it depends on the level at which the discount rate is set. If it is higher than market rates, banks will not be subsidized and if it is lower than market rates they will. I think the Federal Reserve sort of sidestepped that in the report.

Chairman PROXMIRE. Why would anybody go to the discount window if it is higher than the market rate?

Mr. RITTER. First, they would go to the Federal Fund Market and elsewhere and finally if there is no other source of funds and they are desperate and they have tremendous problems they would go to the discount window.

Mr. GIES. There is another reason. Do not forget the Federal Reserve prohibits a bank from repeatedly going to the discount window. If I go there this week and then I insist upon going there next week, I will be most unwelcome.

Chairman PROXMIRE. They would not go to the discount window if they were discouraged from going there and the Federal Reserve policy prevents it but they certainly will not go there if they can go someplace else and if the regular rate in the market is lower.

Mr. GIES. You would have to change the whole rules of the game and set up a pricing mechanism which did not make it objectionable to come to the discount window on principle. You would be permitted to come as frequently and for as long a period and for as much money as you can afford and that is the end of it, but that is not at present the arrangement and Larry is quite right in saying that bankers avoid the discount window simply because the Fed looks very suspiciously at

them and makes it clear that they do not want you to come back and borrow at the Fed.

I have learned this through a long and difficult experience with the Fed.

Mr. RITTER. There are many proposals for what is called a penalty rate, that is, a rate above market rate, because the discount window is to be utilized in emergency situations, a source of lender of last resort funds, and frequently banks or other financial institutions will pay almost anything for funds when they desperately need them just as individuals will. That is the function of the discount window, and if then you have a penalty rate there is no subsidy involved.

Chairman PROXMIRE. There may be no subsidy involved depending on how much the penalty rate brings in. You would not have the penalty in effect consistently, or would you?

Mr. GIES. Yes, and above short terms.

Chairman PROXMIRE. Then, you would not get much business at the discount window and you would not advocate—at least the general tenor of your observation is that this is a good thing, this will provide greater credit for the banking community and that you would not want to discourage discount operations.

Mr. RITTER. No.

Chairman PROXMIRE. Do I misunderstand you?

Mr. RITTER. Yes, you do. That would be quite consistent with my position, that the main function at the discount window is as an emergency safety valve from a lender of last resort and that this would be prefectly appropriate—the price that they charge being above market rates, provided that banks had no hesitation about utilizing the source of funds when they needed it, which would only be when they really needed them because they are paying a penalty to use them.

Chairman PROXMIRE. Gentlemen, I want to thank you very, very much and I apologize if I seem contentious but I wanted to bring out your arguments to the extent I could. This is a most useful morning for us. We have established, I think, a very good record. It will be helpful to other members of the committee and to the Federal Reserve we hope, too.

Additional comments and statements have been submitted to the committee at our invitation and are made part of the record at this point. These include comments from the American Bankers Association, the Independent Bankers Association of America, and the United States Savings & Loan League.

(The statements referred to follow:)

STATEMENT SUBMITTED BY WESLEY LINDOW, OF THE AMERICAN BANKERS ASSOCIATION

Earlier this year the Banking and Financial Research Committee of the American Bankers Association conducted a study of the discount mechanism. In recent years member banks have tended, for a variety of reasons, to avoid using the discount window, and we concluded that there were areas where distinct improvements could be made. Now a special subcommittee has reviewed the steering committee report and we feel that the proposals represent constructive steps in the right direction. We, therefore, hope that the system will proceed to adopt them, subject to such modifications as may seem desirable after suitable review by bankers and others.

The provision for a "basic borrowing privilege" should remove for many banks the uncertainty which they now feel about the use of the discount window. The member banks will now know how much and for how long they can be in debt to their Federal Reserve Banks. The importance of this "right" is that it will enable the member banks to adjust their reserve positions to offset stresses resulting from wide, unpredictable, and temporary swings in both loans and deposits. While the basic borrowing privilege will undoubtedly be sufficient in a great many cases, the steering committee has indicated that additional adjustment credit will be available to assist the banks on approximately the same basis that credit is now available. In short, the discount mechanism will acquire as a result of these proposals a great deal of flexibility and the member banks will be able to rely upon it with greater assurance than in the past.

The steering committee also recognized the need for providing "seasonal adjustment credit" to member banks and it has advanced a formula which will accomplish this objective. This type of credit will be most useful to the member banks in agricultural and resort areas. While it may be used only by a few banks, it should provide them with an extremely useful way of meeting their seasonal needs.

Obviously, the discount rate at which these types of credit will be made available to the member banks will determine in great part the use of the discount window. The steering committee has indicated that the discount rate will be maintained reasonably close to the interest rates for alternative money market instruments and that it is likely to be changed more frequently than it has in the past. We believe that this approach represents an improvement and will enable the discount window to function more effectively.

In general, it seems to us that the steering committee is proposing to modernize the discount mechanism and thereby to enhance its effectiveness as an instrument of monetary policy. If the new proposals are adopted, the discount window will almost certainly become an effective operational instrument. It is likely to be of most help to the small banks, but it will undoubtedly be used by the large banks as well.

Perhaps there has been more discussion about how these new proposals will affect the Federal funds market than on any other point. Some members of the Banking and Financial Research Committee feel that the volume of trading in the Federal funds market will be adversely affected while others hold to a different view. Personally, I am inclined to believe, as a result of my experience and after talking with other individuals active in the money market, that the impact on the Federal funds market will be fairly small and that the market will continue to grow in future years.

The proposals for emergency credit to other financial institutions and support for distressed markets undoubtedly represent the existing policy views of the system. These measures are probably necessary although there is insufficient experience to indicate how much they may be used.

The steering committee also reports that efforts are being made to establish uniform procedures for discount administration. In a survey of the discount function made by this committee in connection with the study referred to above, it was disclosed that many bankers felt that there was a substantial lack of uniformity from district to district. The present efforts on the part of the Federal Reserve System to coordinate the policies of the various banks are commendable and we hope that further progress will be achieved.

In conclusion, we believe that the Federal Reserve study represents a significant step toward achieving a viable discount function. Implementation of the proposals, with such improvements and modifications as may now be developed, will go a long way toward making the discount window more responsive to the needs of member banks and toward attaining more effective and flexible administration of broad Federal Reserve policies. However, we are impressed with the magnitude of the task which still lies ahead. It will be a major undertaking to translate the committee's recommendations, intact, into an effective revision of Federal Reserve Regulation A. It may be difficult to achieve full uniformity in discount administration among the 12 Federal Reserve districts. Other unexpected difficulties may be encountered. Yet, we are quite positively impressed with the progress embodied in the present report. And we are optimistic that the provisions recommended in it can be successfully put into operation

STATEMENT SUBMITTED BY T. H. MILNER, JR., PRESIDENT, AND BRADFORD BRETT, CHAIRMAN, FEDERAL LEGISLATIVE COMMITTEE, OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Our association welcomes the proposals, and prospective reforms in the Federal Reserve "discount window" operations, designed to enable commercial banks to meet more effectively the credit needs of their communities, as recommended in this Fed report after 3 years of study.

Our association welcomes the changes proposed in present regulations to give member banks more generous borrowing privileges, seasonal advances and additional short-term borrowing permissives under certain circumstances.

We approve proposed reforms to include emergency credit for nonmember banks, savings and loan, mutual savings banks, insurance companies and possibly credit unions. Until such time as the Fed, in its role of monetary management, is empowered to fix the reserve requirements for financial institutions other than commercial banks, we believe such credit should be limited to emergencies.

The Independent Bankers Association approves the proposals to amend monetary policy procedures to make possible frequent changes, perhaps even weekly, in the discount rate at which banks borrow from the Fed. Our association welcomes the Joint Economic Committee hearings to provide a forum for full discussion of the Fed report, with comment by Fed spokesmen, the banking community, and the combined academic and economics community.

As president and Federal legislative chairman of our association, we are convinced that any plan the Federal Reserve adopts to simplify and liberalize the procedures to enable member banks to borrow from the Fed will be an improvement.

Our association wishes to affirm and reaffirm our widespread membership conviction that the Fed should encourage the smaller banks to borrow from the Fed. In this connection, we believe the powers of the Federal Reserve to lend should be amended and updated as the Board has requested of the Congress. We likewise believe the Fed should be encouraged to contribute more in a helpful way to the operation of banks, the better to enable them to meet and solve the myriad problems which confront them.

As a broad part of the general problem of maintaining the strong and viable dual banking system that is now traditional in our great land, our association is fully aware that many services and functions are now being handled by the correspondent banks, and is concerned that should the correspondent banks continue to merge and pursue the branch banking or holding company competitive route, that the time will soon come when there will no longer be large banks with which the community banks can do business.

Therefore, we particularly see an opportunity, coincident with this Fed reappraisal and study, to encourage nonmember banks to join the Fed for definite and beneficial reasons.

We note with approval that Fed Gov. George W. Mitchell, in his appearance before the committee on September 11, reviewed the historic development of Fed lending practices, and reaffirmed three long standing principles of Fed lending, to meet short term member bank needs for funds, to lend to member banks in times of emergency or adversity, and to buttress the entire financial system as lender of last resort.

We are hopeful, that in practice when approved after full and free discussion and comment, the more clear-cut access to Fed lending facilities will halt and reverse a climate and trend that has led a small but growing number of banks to withdraw from membership in the Fed system. We believe that the proposed redesign of the discount mechanisms will do much to relate the Federal Reserve more closely to changing community and banking needs.

We note that the Fed Board of Governors has not yet taken substantive action on the proposals contained in the reappraisal study. We are glad that the proposals are receiving review and comment, some of it critical. Should the committee hearings be extended or resumed, we would welcome further opportunity to appear and comment, but content ourselves at this time with submission of this written statement.

We welcome Governor Mitchell's assurances to your committee that the Fed is seeking to establish "closer touch with the prevailing economic climate," and wish the Fed the best of success in its endeavor to better serve the "evolving needs of the community." Our association membership of some 6,600 community banks, will benefit from the success of this endeavor, and more importantly, the communities they serve will benefit.

STATEMENT SUBMITTED BY RICHARD T. PRATT, ECONOMIST, U.S. SAVINGS AND LOAN LEAGUE

The Federal Reserve is to be commended for undertaking a reevaluation of the discount mechanism. In commenting on the Fed's proposals, two points should be made. First, the U.S. Savings and Loan League has not had the benefit of all the research which the Fed has had on this project. Secondly, the relationships which the Fed wishes to establish with the commercial banking system do not concern us except as they affect the savings and loan business and its ability to provide adequate mortgage credit for American mortgage needs.

Having made the above statement, a brief exception to it is undertaken. It is important that small commercial banks not be excluded from the obtaining of credit which is available to large banks. Credit market imperfections should not prohibit small banks from making reserve adjustments which can be made by the large banks. The Fed's concern for this matter is strongly endorsed. A second matter which we endorse is the provision of a mechanism for evening out seasonal credit variations in local areas.

The remaining remarks are confined to the relationship of the Fed's proposals as they relate to the savings and loan business and mortgage financing. The two topics of substantial concern are the proposal as it relates directly to home financing and the effect which implementation of the Fed's proposals may have on nonbank thrift institutions.

FINANCIAL INTERMEDIARIES AND THE RELATIONSHIP BETWEEN DISCOUNT WINDOW OPERATIONS AND THE MONETARY ENVIRONMENT

The chief objective of the Fed's proposals is to liberalize discount privileges "for the purpose of facilitating short-term adjustments in bank reserve positions." [1] This position is laudable as an expression of the regulatory authority's concern for the business it regulates. Nevertheless, possible direct or indirect effects from the policy on the balance of the economy should be carefully considered.

The liberalization of the discount window which facilitates commercial bank adjustments to monetary difficulties may aggravate the adjustment difficulties of nonbank financial institutions. The reason for these adjustment difficulties stem from two factors inherent in the proposals. The first factor is the timing of bank borrowing at the window. The second factor is the structural relationship between bank borrowing at the window and open-market operations required to maintain a desired monetary policy.

Banks can be expected to aggressively use their basic borrowing privilege in periods of tightening monetary conditions and make little use of it in other periods. This behavior is almost guaranteed by the

[1] Report of a System Committee. "Reappraisal of the Federal Reserve Discount Mechanism," Board of Governors of the Federal Reserve System, p. 1.

fact that "related market rates would move higher relative to the discount rate in periods of restraint and lower relative to the discount rate during periods of ease." [2]

This means that significant surges would exist in lending activity at the discount window in times of credit restraint. Similarly, substantial repayments would occur during periods of reduced monetary restraint. If the escape hatch offered commercial banks affected no other sectors of the economy, little objection could be raised other than the perhaps minor point of the Fed's subsidizing the bank system by lending at below market rates. The complicating fact is that the expanded use of the window may further complicate a difficult monetary environment for nonbank financial intermediaries.

THE LIBERALIZED WINDOW AND THE PROVISION OF ADDITIONAL HOUSING CREDIT

Any suggestion that the proposed liberalization of the discount privilege would be a substantial boon to housing in times of monetary difficulty must be rejected. The reasons for this rejection are as follow.

1. The Fed has proposed that it provide credit to nonbank financial institutions only when "other sources of credit have been exhausted and failure of the troubled institutions would have a significant impact on the economy's financial structure." [3] Housing markets may be severely depressed, homebuilding activity reduced and serious housing shortages develop without threat to the "economy's general financial structure." Such criteria as the Fed suggests is inadequate and nebulously defined.
2. The Fed's desire to channel emergency credit to nonbank institutions through member banks is both inequitable and unrealistic. It is unlikely that an effective borrower-lender relationship can be attained between the commercial banking system and the savings and loan business when natural competitive pressures are apt to be at a peak. It is inequitable to give commercial banks control over the ability of their competitors to do business and to provide the community with mortgage credit. It is unlikely that commercial banks will use additional reserves to supply mortgage credit when demand for other better yielding loans is at a peak. If commercial banks are forced to supply mortgage credit, they would naturally tend to do so as direct lenders, rather than as lenders to the savings and loan business.
3. The Federal Reserve has announced that credit to nonmembers will only be provided at a "significant penalty rate vis-a-vis that charged member banks". [4] This means that housing and home financing which is most sensitive to changing interest rates will have a second penalty levied against it by having to pay more for credit than the less seriously affected sectors surrounding it.
4. The mechanics of providing greater access to the discount window for member banks during periods of monetary tightness may actually reduce the amount of mortgage credit available in the economy. The following section treats this question at some length.

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[2] Ibid., p. 20.
[3] George W. Mitchell, statement before the Joint Economic Committee on the "Reappraisal of the Federal Reserve Discount Mechanism," Sept. 11, 1968, p. 9.
[4] Report of a System Committee, p. 19.

The Fed restricts or eases monetary policy by destroying or creating bank reserves. Reserves are created by either lending reserves through the discount window or purchasing securities on the open market. Similarly, reserves are destroyed by terminating advances or by selling securities on the open market. If it is desirable that a certain level of reserves are to be maintained, because of the requirements of monetary policy, any creation of reserves by one mechanism must be offset by destruction of reserves through the alternative mechanism.

In recent years, the Fed has relied on open market operations to implement monetary policy. There has been little opportunity for two of the Federal Reserve policy instruments to move in opposite directions because of the reliance on a single instrument. With the discount window opened and its use encouraged during periods of monetary tightening, a leak apparently will be created in the control mechanism.

What happens with greater lending through the discount window? Every dollar lent through the window will increase the lending capacity of the commercial banking system. A new dollar of reserves is also being created. Each of these additional dollars of new reserves must be offset through open market operations by selling Government securities held by the Fed. The sale of securities by the Fed drives down their price and hence drives their interest rate up. Driving up interest rates on short-term money market obligations encourages the transfer of funds from thrift institutions to the security markets and reduces the ability of mortgage financing institutions to compete for funds. Thus, the Fed in helping commercial banks adapt to changing monetary conditions can well magnify the difficulties of the nonbank financial intermediaries.

It can be argued that the Fed's more liberal use of the discount window will have a destabilizing effect on mortgage lending flows in periods of monetary ease as well as monetary tightness. When the Fed is easing monetary policy, the banks will probably reduce their advances to the Federal Reserve. A rapid repayment of advances must be offset by System purchases. The additional System purchases would tend to drive short-term rates down still further and thus cause a sharp increase of funds flowing to mortgage lending institutions. The possibility of this development does not seem remote when the Fed's report states:

"The existence of the discount mechanism, however, provides a means for individual banks to cushion temporarily the impact of such policy moves and therefore enables the trading desk of the Federal Reserve Bank of New York to carry out the System's open market operations more aggressively than would otherwise be practicable." [5]

By increasing the feast or famine response of intermediaries to monetary change, the more liberalized use of the window may aggravate the cyclical nature of housing activity—further retarding it when it is already suffering from the effect of tight money and stimulating it when it may already be producing at near capacity.

The potential sums involved in under use of the discount window may be substantial. The Fed did not provide dollar figures in their report or in the statement of George Mitchell to the Joint Economic Committee. A conservative estimate based on the capital stock and surplus of member banks indicates a basic borrowing privilege of

[5] Report of a System Committee, p. 4.

perhaps $2 billion. Assuming some increase in the banking membership of the Federal Reserve and use of the maximum allowable lending by the Fed, this figure might be in the neighborhood of $4 billion. Specific information from the Fed as to the magnitudes involved would aid in the consideration of this proposed action.

The conservative $2 billion may be enough to seriously disrupt money markets and interfere with mortgage lending, nonbank financial intermediaries. Mr. Martin, Chairman of the Federal Reserve System, when testifying on H.R. 16092 in June of 1968 pointed out the changes to housing involved in providing special credit which must be offset by open market operations. Mr. Martin states:

"If the Federal Reserve sold Treasury bills to offset purchase of this magnitude, borrowing costs would rise sharply for the Treasury and for other nonmortgage borrowers. We have recently seen how rapidly Treasury bill rates can climb merely under the apprehension that financial markets would be subject to considerable additional future pressure * * *. Such upward interest rate pressures would, in turn, divert flows of savings from the depository institutions directly to the market. This diversion would magnify the effects of tight money on the availability of mortgage credit from nonbank intermediaries. It would affect particularly adversely the savings and loan associations and mutual savings banks that specialize in residential mortgage lending."[6]

If Mr. Martin's statements are a valid criticism of providing direct credit to mortgage lenders caught in a monetary squeeze, they would seem to have even greater application concerning the provision of credit to commercial banks, essentially nonmortgage lenders. All of the perverse effects would seem to be involved without the redeeming quality of providing direct credit for mortgage financing.

AN ALTERNATIVE PROPOSAL

Many of the threats involved for mortgage lending and the operation of nonbank financial intermediaries could be avoided by a simple modification in the proposals. If the Federal Reserve were to couple its wider provision of discounts with a proscription against providing such discounts at below alternative market rates, all of the proposed benefits could be obtained with few of the threats to other existing economic activities. The Fed does not argue that Federal funds are too expensive for the small bank; rather, it argues that they are not available. Thus, making them available at a rate equal to or minimally above some benchmark market rate would make funds available while not providing misleading price signals. The provision of funds at market rates would largely remove the need for the Federal Reserve to engage in the offsetting open market operations discussed earlier. On a national basis this is so because no net incentive to borrow from the Fed would exist.

A possible reason why the Fed has not suggested the use of market rates or a minimal penalty rate for all borrowers is that they wish to combine the stated objectives of the discount amendment with a subsidy to member banks. The reason for such a subsidy would be to stem

[6] Wm. McChesney Martin, hearings before the Committee on Banking and Currency, House of Representatives, on H.R. 16092, June 1968, p. 103.

attrition in the membership of the Federal Reserve. Since 1957, the assets of all commercial banks have grown from $222.7 billion to $451 billion, an increase of 102.5 percent, while the assets within the Federal Reserve System have grown from $188.8 billion to $373.6 billion, a gain of only 97.9 percent. In 1957, the Federal Reserve System contained 47.1 percent of the Nation's more than 13,000 commercial banks. By yearend 1967, it contained 44.2 percent.

Stemming attrition from the Federal Reserve System, or increasing the percent of financial assets over which the Fed has direct control is not discussed in the discount proposals. However, if such a goal is implicit in the proposals for amending the discount procedure, the appropriateness of attaining the goal in this manner is subject to question.

Whether the goal of the Federal Reserve is to increase the attractiveness of membership in the System or ease reserve adjustments of commercial banks, the objective is not questioned. Safeguards should be provided such that the attaining of the objectives, whatever they may be, does not provide substantial hardships on the balance of the economy. Proposals which increase the sensitiveness of housing to monetary changes seem especially questionable.

Chairman PROXMIRE. I would like to say at this time that any comments the Board of Governors may choose to make responding to Professor Friedman's comments will be accepted for inclusion in the record up to the time of publication of these hearings.

The committee will stand in adjournment subject to the call of the Chair.

Thank you.

(Whereupon, at 12:10 p.m., the committee was adjourned, subject to the call of the Chair.)

(The following letter was received from the Board of Governors of the Federal Reserve System in response to comments included in the letter of Professor Friedman which was incorporated into the record (see p. 32).)

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, October 15, 1968.

Hon. WILLIAM PROXMIRE,
Joint Economic Committee,
U.S. Senate,
Washington, D.C.

DEAR SENATOR PROXMIRE: I would like to take this opportunity to respond to the issues raised in the September 13 letter sent to you by Prof. Milton Friedman with regard to the proposals currently under consideration for redesign of the Federal Reserve discount mechanism.

As you know, the System, presently as in the past, sees the role of the discount mechanism in a different light than does Professor Friedman. We agree that the advent of Federal deposit insurance substantially lessened the possibility of "runs" on the banking system and view this insurance as a vital part of a dependable and effectively operating

financial system. However, the prevention of runs is not and never was the sole or even the most important function of the discount window. In a highly fragmented banking system such as that existing in the United States, it is important that there be some method whereby individual member banks can obtain Reserve Bank credit quickly and efficiently to meet their individual reserve needs.

The net reserve needs of the banking system as a whole can be and are promptly and effectively met by open market operations. However, there are at least two factors that can combine to prevent these operations from adequately responding to the needs of individual banks. First, the size and timing of short-term reserve pressures often varies widely from bank to bank. Thus, individual banks may be experiencing outflows of funds far in excess of reasonable expectations given current monetary conditions, whether of ease or restraint. Their problems in meeting these needs cannot be allowed to dilute the effectiveness of general policy, but neither should these institutions be exclusively penalized because of their special needs for funds, which may be quite apart from the national credit conditions being dealt with by open market operations.

A second and closely related factor is the imperfection of distributive financial mechanisms in the United States. With perfect mobility of credit, the impact of any general monetary policy would be equitably distributed throughout the financial system relative to the opportunities for profitable employment of funds. However, this degree of mobility simply does not exist. Financial markets and mechanisms often do not function with sufficient speed and elasticity to guarantee that a bank can always effect its needed adjustments through these means, and very large numbers of member banks, practically speaking, do not have adequate access to such markets. These markets have clearly improved in the past, and doubtless will continue to do so. But for numerous banks, the ability to tap these markets expeditiously has not developed commensurately with local credit demands, and the privilege of borrowing from time to time from the Federal Reserve can make such banks more efficient in serving their communities by giving them the needed flexibility for an orderly working out of balance-sheet adjustments.

In addition, it is important to recognize that the discount mechanism also serves, in effect, as a "safety valve" for open market operations. Without such a mechanism, open market operations would have to be limited by the need to avoid impact on individual institutions. However, because individual banks do have the ability through borrowings from the central bank to offset temporarily what at times may be a particularly harsh impact of open market operations, such operations can be conducted more vigorously and in accordance with the credit and monetary needs of the economy as a whole. Thus, it is my judgment that the existence of the discount window not only does not complicate the task of overall monetary management, but in fact eases it.

Furthermore, I believe that this latter beneficial effect would be increased with the adoption of the proposal for its redesign. One of the overall effects of the change would be to shift a somewhat larger part of the reserve adjustment initiative to the individual member bank. In all probability this can relieve open market operations of a portion

of the responsibility for accommodating these short-run reserve needs, thus allowing such operations to be undertaken with increased attention to the longer run concerns.

I recognize that one other effect of the proposed new discount mechanism would probably be some lowering of the levels of liquidity maintained by certain groups of banks as they are able to rely on the Federal Reserve for increased credit to meet temporary unforeseen or recurring needs. However, this effect is expected to be concentrated in smaller rural banks which, because of anticipated need and lack of access to the central money market, presently maintain an unnecessarily high portion of their resources in highly liquid but low-yielding assets such as U.S. Government securities, or, in a surprising number of cases, in nonearning excess reserves. This tendency on the part of some country banks can, of course, result in the credit needs of the communities they serve being less than fully met.

On the other hand, the proposed redesign is not likely to have any significant impact on the liquidity of the larger city banks which already have convenient access to market sources of funds. In any case, the supervisory function of the Federal Reserve and that of the Comptroller of the Currency will continue to operate to insure that individual member banks maintain adequate liquidity.

Professor Friedman's characterization of the discount window as conveying a subsidy to member banks must be based on some misreading of the proposal. The rate charged on borrowing under the new discount arrangements would not, as Professor Friedman speculates, average 2 percentage points below market rates, but on the contrary would be kept in reasonably close alinement with market rates. This is a clearly stated aspect of the proposal, and it assures that there will be no significant subsidy to banks or cost to the U.S. taxpayer. Moreover, access to the window is normally limited to member banks, and the value of this privilege ought to be weighed in light of the requirement that these banks maintain a portion of their deposits in a nonearning capacity as reserve.

I am grateful for this opportunity to express my views on Professor Friedman's comments. As you know, the Board is actively seeking reactions from all sources on the proposals for redesign of the discount mechanism and is endeavoring to give full and open consideration to all comments received. I feel that this process should include stating opposing views when, as in the present case, it is felt that important misconceptions are involved in those comments. I would appreciate it if you would include this letter in the record of your hearings on the discount mechanism.

Sincerely,

George W. Mitchell.