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FEDERAL RESERVE DISCOUNT RATE  
POLICY ACTIONS: 1951-1965

by

Randolph George Urbanec

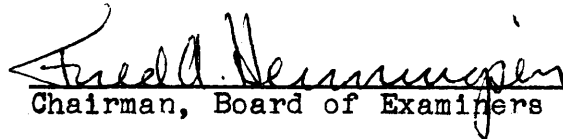
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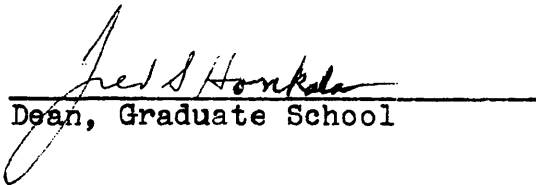
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## CHAPTER I

### THE HISTORY OF THE FEDERAL RESERVE SYSTEM AND ITS UTILIZATION OF MONETARY CONTROL MECHANISMS

The Federal Reserve System was created under the Federal Reserve Act of 1913 to execute monetary policy. Monetary policy "attempts to provide the public with the cash balances and bank credit necessary to sustain growth in output at high levels of employment and to maintain a stable purchasing power for the dollar."<sup>1</sup>The Federal Reserve Board, in its execution of monetary policy, utilizes various mechanisms in affecting money, with the use of the discount rate as a regulator of the cost and availability of funds or credit. The Federal Reserve Board of Governors, the Federal Open Market Committee, and the officers of the 12 Federal Reserve Banks all share the authority for making monetary policy. Essentially, they decide the degree of restraint or encouragement to be imposed on bank credit expansion. In attempting to reach policy goals, the Federal Reserve System (hereafter referred to as the Fed) takes action through its open market operations, discount rate, and reserve requirement adjustment power. These mechanisms have a decisive impact on the availability and cost of bank reserves. As such, interest rates and conditions of credit, availability of bank credit, and the supply of money are directly affected

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<sup>1</sup>Jack Guttentag, "Credit, Availability, Interest Rates, and Monetary Policy," Southern Economic Journal, XXVI (January, 1960), p. 219.

by Federal Reserve Monetary Policy.

Prior to the Treasury-Federal Reserve Accord of 1951, the Fed's monetary policy was unstable, lacked flexibility, and rather chaotic. Before World War I, the Fed was mostly engaged in developing its organization, having no acute problems to meet. During the war, the Fed assisted in financing it by establishing a preferential rate on paper secured by government obligations when it was discounted by member banks with the Federal Reserve Banks. The rate was fixed at a level which made it possible for member banks to finance public purchases of government securities on an installment basis. The rate paid to member banks by purchasers of these securities was the coupon rate on the bonds. The banks, then, discounted the paper with the Fed banks at a slightly lower rate. The end result was large expansion of member bank and Fed bank credit. This large supply of money along with a short supply of consumer goods caused the Fed to raise the discount rate to 7% by the spring of 1920. The resulting collapse was attributed to the Fed along with the previous inflation, but a Congressional investigating committee cleared the Fed on these counts.<sup>2</sup>

From 1922 to World War II, Federal Reserve monetary policy varied considerably.<sup>3</sup> Stability of monetary policy during the 1922-1929 period aided in giving the United States prosperity.

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<sup>2</sup>E. A. Goldenweiser, American Monetary Policy, (New York: McGraw-Hill, 1951), pp. 131-137.

<sup>3</sup>Ibid., pp. 138-182.

During this time, a national credit policy was established and the right of the Fed to change the discount rate was asserted. Prior to the panic of 1929, Fed actions were useless in combating the speculative movement unless money was shut off to the stock market operations, which was beyond the Fed's control. However, the Board turned down continual demands for increases in the discount rate asserting that the speculation movement wasn't any of their business. From 1929 to 1950, the Fed embarked on a policy of easy money, with variations. Federal Reserve monetary policy during the depression did as much to help combat it as it could considering the situation was worldwide. From 1929-1933, easy monetary policy consisting of reduced discount rates and failure to pursue a vigorous open-market policy were evident. During 1933-1935, the Fed pursued additional monetary and credit ease consisting of discount rate reductions and open market operations. During 1936-1938, the Fed resorted to increases in reserve requirements to cover up the \$10 billion in excess reserves in 1936. Although the decline of 1937 wasn't directly attributed to these reserve adjustments, it showed the Fed what a powerful weapon they had.

During World War II, the Fed was committed to provide the Government with low-cost funds. The war was subsequently financed by enough Federal Reserve credit to enable the Government to borrow more than \$200 billion. The Fed stood ready to buy U. S. Government securities at or above par--at a 2 1/2% interest rate on long-term bonds and lower rates on short-term



issues. This meant that these securities held by member banks were as liquid as cash reserves, since they could be converted to cash at or above par at any time.<sup>4</sup> As such, Federal Reserve control mechanisms and their usefulness as anti-inflationary measures were obliterated.

The use of monetary control mechanisms as an integral part of monetary policy was diminished through "pegging" Government securities. As Marriner Eccles, then Chairman of the Board of Governors, told Congress in 1947, "Control of interest rates on Government securities...is not an effective instrument for achieving monetary objectives."<sup>5</sup> This statement reflected the inappropriateness of supporting Government securities during the post-war period, which, in turn, produced a skepticism about the purpose of monetary policies. This skepticism was reinforced by the results of several surveys conducted during the late 1930's which suggested that businessmen were little affected by interest rates.<sup>6</sup> The imposed stability of interest rates by the Fed was believed to continue into the post-war years. However, those who considered the possibility of releasing the Fed from its wartime commitment to stabilize Treasury security prices and yields rejected this alternative due to a fear that fluctuations in interest rates

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<sup>4</sup>Federal Reserve Bulletin, XLI (January, 1948), p. 16.

<sup>5</sup>Ibid.

<sup>6</sup>J. F. Ebersole, "The Influence of Interest Rates Upon Entrepreneurial Decisions in Business," Harvard Business Review, XLII (Autumn, 1938), pp. 35-40.

and security prices might adversely affect the willingness of investors to continue to hold the swollen public debt. And, interest in monetary policy was shifted to a new weapon, fiscal policy, which seemed to promise all the economic control needed.

The realities of the post-war world led to recognition that skepticism about the usefulness of flexible monetary policies had been exaggerated and that an inflexible monetary policy involved difficulties. This recognition was brought about, primarily, by three influences: (1) The major post-war problem turned out to be inflation rather than deflation, (2) Fiscal policy couldn't be relied on solely to cure economic ills, and (3) Inflexible monetary policy, i.e. holding interest rates stable, proved to involve far more difficulties than had been anticipated.

Since inflation rather than deflation was a major post-war problem, interest in monetary policy revived due to two reasons. First, much of the skepticism about monetary policy's usefulness had been based on the assumption that monetary policy is ineffective in dealing with depressions. However, the post-war inflation proved this irrelevant. Secondly, inflation was widely believed to be a monetary phenomenon and its occurrence induced a search for monetary cures.

Gradual disappointment of fiscal policy also helped revive the idea that monetary policy might be effective. Fiscal policy had caught the imagination of economists after

John M. Keynes introduced his theories.<sup>7</sup> Keynes put the major emphasis on the possibilities for government to influence the economy through direct investment and taxation. Government, he argued, could inject or withdraw income from the economy which would have a multiplied effect on income because people ordinarily spend the greater part of additions to income and save only a fraction. Public investment could be varied, if necessary, to stimulate total income by a multiple of itself. Taxation could have the same effects in the opposite direction as could reduced public investment. The leverage or multiplier of a given amount of investment or taxation would depend upon the consumer's marginal propensity to consume. However, the consumption function as part of fiscal policy used as a sole control mechanism was <sup>not</sup> feasible due to the need for monetary policy in support of its operation.

The conduct of the prevailing inflexible monetary policy was becoming a troublesome problem.<sup>8</sup> During World War II, yields and prices of Treasury securities had been stabilized in a situation in which investors had few alternative outlets for their money. Since post-war business was booming and investment opportunities were wide-spread, "pegging" Government

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<sup>7</sup>John M. Keynes, The General Theory of Employment, Interest, and Money, (New York: Harcourt Brace, 1936), pp. 95-96.

<sup>8</sup>James. L. Knipe, The Federal Reserve and the American Dollar (Chapel Hill: The University of North Carolina Press, 1965), pp. 50-62.

securities prices and yields not only prevented the Federal Reserve Board from using its powers to limit inflation, but became an inflationary force in itself. The pegging policy made the entire marketable debt, regardless of stated maturity, convertible on demand into cash at the option of the holder and, therefore, practically as liquid as money. Moreover, so long as all Treasury maturities were supported at fixed prices or yields, control of the money supply passed over to the holders of Government securities. The Fed had to buy to maintain support-price levels regardless of what happened to the money supply.

The Federal Reserve Board, however, began to move cautiously toward a somewhat greater degree of flexibility as early as 1946.<sup>9</sup> The approach was to gradually withdraw from the commitment to buy short-term pegged Treasury securities. With this, the Fed wouldn't lose control of the money supply if holders of the still-supported, long-term Treasury obligations began to sell them to the Fed at the support prices. Free from concern about short-term yields, the Fed could sell short-term Governments to recapture the reserve funds it released when it purchased long-terms. The next development the Fed had to handle was massive sales of nearly \$11 billion of long-term Government bonds in the year ending

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<sup>9</sup>United States Congress, Subcommittee on General Credit Control, Monetary Policy and the Management of the Public Debt; Replies To Questions and Other Material, 82nd Congress, 2nd Session, 1952, Part I, pp. 52-64.

November, 1948, by insurance companies, banks, and other investors who were raising cash for higher yielding private loans and who were also protecting themselves against the possibility that the Fed would be unable, or unwilling, to support long-term Government bond prices indefinitely.<sup>10</sup> Had the Fed not taken the precaution to free short-term Government securities, the full impact of these \$11 billion bond purchases would have caused a corresponding rise in bank reserves and an even larger increase in the money supply. As it was, the sales of short-term Government securities offset the effects of the purchases of long-terms. Since the Treasury was retiring securities out of its cash surplus, the Fed holdings of Government securities actually declined during this period.

This 1947-1948 experience could have been more chaotic and disastrous. Had the torrent of sales of long-term bonds gone on for another year at the same rate, it would have exhausted the Fed's holdings of short-terms which were being sold to prevent the expansion of bank reserve positions and the money supply. It was only a coincidence that the 1949 recession developed to slow credit demands and sales of bonds by lending institutions. However, the Fed had not been able to prevent the private sector from substantially increasing

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<sup>10</sup>Ibid.

its liquidity by the trade of long-term bonds for short-term obligations sold by the Fed.

In retrospect, the Federal Reserve Monetary Policy was rendered temporarily useless by the Truman Administration in the 1946-1948 cycle. The Fed was forced to rely almost entirely on (1) the regulation of consumer credit, and (2) pleading with commercial banks and other interests to exercise self-control, while (3) unsuccessfully requesting legislation to permit the institution of a new kind of supplementary reserves which, supposedly, would restore the general monetary control mechanisms to working order.<sup>11</sup> The few feeble attempts at the use of the discount rate and reserve requirement adjustment mechanisms were meaningless due to the Fed's pre-occupation with Government pegged securities. Chairman Eccles was told in late January, 1948, that he was not going to be re-appointed Chairman of the Board.

The outbreak of the Korean War in June, 1950, brought about a wave of inflationary borrowing and spending. The result was a struggle between the Federal Reserve Board, the Treasury, and the President. The issue was whether the long-term Government bond market should continue to be supported on a 2 1/2% basis. The outcome was the Treasury-Federal Reserve Accord of March 3, 1951. More will be

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<sup>11</sup>Knipe, op. cit., pp. 54-61.

mentioned of the Accord later. For the present purpose, the Accord meant that the Fed was to conduct flexible monetary and credit policies as needed to influence appropriately the general economic situation.<sup>12</sup> Basically, it restored to the Federal Reserve Board the "freedom to pursue an independent monetary policy, subject to the obligation to maintain orderly conditions in the government securities market."<sup>13</sup>

Since 1951, the Fed has followed a fairly vigorous counter-cyclical monetary policy. Counter-cyclical monetary policy is that which allows the Fed "to exert pressure on member bank reserves and causing interest rates to rise during business expansion and shifting, as quickly as needed, to a policy of credit ease when business declines and prices stop rising rapidly."<sup>14</sup>

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<sup>12</sup>United States Congress, op. cit., pp. 362-368.

<sup>13</sup>Robert Aaron Gordon, Business Fluctuations (New York: Harper & Row, 1961), p. 586.

<sup>14</sup>Ibid., p. 587.

## CHAPTER II

### FEDERAL RESERVE MONETARY CONTROL MECHANISMS

United States monetary policy is, primarily, the regulation of the volume of member bank reserves. The Federal Reserve Board, in its execution of monetary policy, has three control mechanisms at its disposal: (1) the open market operation, (2) member bank reserve requirement adjustment, and (3) the discount rate. Each of these mechanisms directly affect member bank reserves.

#### The Open Market Operation

The Federal Reserve Board, in its daily operation, relies upon open market operations as its most sensitive and effective instrument for regulating member bank reserves. The reserve base is regulated weekly and monthly through the purchase and sale of securities by the central bank. When the central bank sells securities, member bank reserves are reduced by the amount bought. The reverse happens when the central bank buys securities.

During monetary restraint, open market operations tend to provide a smaller amount of bank reserves than is called for by the demands for bank credit.<sup>15</sup> As such, the needed reserves

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<sup>15</sup>David P. Eastburn, The Federal Reserve on Record; Readings on Current Issues from Statements by Federal Reserve Officials, (Federal Reserve Bank of Philadelphia, 1965), p. 99.



must be obtained through the discount window. In determining how open market operations will affect the potential for bank credit and monetary expansion, the Board must consider the amount of reserves member banks have borrowed at Reserve banks or are likely to borrow at the prevailing discount rates. The amount of excess reserves of member banks must also be considered. The necessity of this is that increases or decreases in the supply of funds based upon bank reserve requirements have a great impact upon interest rates.

A reversal of monetary restraint also sees open market operations and discount policy coordinate. As reserves are supplied at the Fed's initiative, one result is that member banks are enabled to repay their indebtedness at Reserve banks. As such, excess reserves at member banks accrue and are used for loan and investment expansion.<sup>16</sup>

#### Member Bank Reserve Requirement Adjustment

Changes in member bank reserve requirements, less flexible and adaptable than open market and discount operations, are used occasionally. Usually, these changes are applied to situations of more than temporary significance. Reserve requirement percentages have been reduced in recessions, for example, to make reserves available at the same time to all member banks. Sometimes reserve adjustments are made to help

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<sup>16</sup>Ibid., p. 100.

offset sustained gold flows or to accomodate structural adjustments in the banking system. Reserve adjustments are sometimes used in coordination to discount rate changes to intensify the degree of restraint or ease desired by the Fed.

When member bank reserve requirements are changed, the aggregate effect on market rates of interest is similar to open market operations, although there may be a difference in the timing of the effect. Most of the impact of open market operations on interest rates is through the multiple expansion or contraction of bank credit and is based on the change in bank reserves which works themselves out over a fairly short period. The operations themselves, however, may be undertaken over a longer period. In the case of member bank reserve requirement changes, the impact on the market interest rates are fairly immediate since the requirements become effective on a selected date.

#### The Discount Rate

Basically, the discount rate is the rate charged by the Fed when member banks come to it to borrow reserves in times of stringency. The Fed considers the use of the discount window a privilege, not a right. Discount rates are adjusted by the Fed to signal to the public a change in or continuation of prevailing monetary policy, to affect the cost and availability of loanable funds, and to establish a pivotal rate around which other short-term interest rates tend to form.

Perhaps the main purpose of the discount window is to "permit a gradual and orderly response on the part of banks to the reserve pressures that accompany monetary policy."<sup>17</sup>

Member banks borrow from the Federal Reserve Banks through two methods. The first is when they rediscount short-term commercial, industrial, agricultural, or other short-term paper, with recourse on the borrowing bank. This procedure is called discounting and is practically obsolete. The second method is called advance. In this practice, the member banks may give their own promissory notes secured by paper eligible for discounting, by Government securities, or other satisfactory collateral as determined by the Fed. Nearly all member bank borrowings are in the form of advances and discounts under Sections 13 and 13a of the Federal Reserve Act. Here, advances are secured by United States Government securities and discounts of, and advances secured by, eligible paper. The other way of obtaining funds from the Fed is through advances under Section 10(b). Here, the interest rate is one half percent higher than under sections 13 and 13a due to the nature of the paper secured. Most member bank borrowing is in the form of advances and discounts as under Sections 13 and 13a due to convenience because collateral is free of credit risk, appraisable as to value, and more readily supplied

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<sup>17</sup>The Federal Reserve System-Purposes and Functions, A 50th Anniversary Edition prepared by the Board of Governors of the Federal Reserve System (Washington, D. C., 1963) p. 40.

in large amounts.

In the borrowing procedure, the member bank's reserve balance at the Fed is affected. When a member bank borrows, the amount of the loan is added or credited to its reserve balance. When the loan is repayed, the amount is deducted from or charged against its balance. Advances to or discounts for a member bank are made for periods of up to 15 days.<sup>18</sup>

Although monetary policy is ordinarily patterned after national rather than regional considerations, in the early years of the Fed, there was some tendency toward regional discount rates.<sup>19</sup> Prior to 1922, discount rates varied according to class of paper, maturity, and security. A differential pattern of regional discount rates was established during the 1922-1923 period. At that time, higher and less frequently changed discount rates were experienced in agricultural regions than in industrial and financial districts. During 1927, discount rates became uniform. Since the 1930's, discount rates in all Federal Reserve districts have been uniform except during relatively short intervals.

Discount rates still vary in different Reserve districts, though for a short time only. The Board of Directors of the

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<sup>18</sup> Ibid., p. 41.

<sup>19</sup> The Federal Reserve and the Treasury, Prepared for the Commission on Money and Credit by the Board of Governors of the Federal Reserve System and the United States Treasury Department (Englewood Cliffs: Prentice-Hall, 1963), p. 156.

individual Reserve banks decide upon a discount rate "every fourteen days or less if deemed necessary."<sup>20</sup> Although the discount rate which is set isn't required to be the same as that fixed by all or a part of the other member banks, the Board can produce uniformity by disapproving all rates which aren't the desired rate at the time. For example, in 1957, the New York bank reduced its discount rate from 3 1/2% to 3 1/4% while the remainder went down to 3%. The Board never approved the New York reduction until it was in line with the other banks. Although these instances are rare, the Board can hold up rate change application until the majority adjusts, then approve.<sup>21</sup>

A lag in discount rate adjustments by Reserve banks is not alarming. A lag of two or three business days could reflect a difference between Reserve boards as to the timeliness of the rate change or a difference in the regular meeting dates. Longer periods of postponement may be due to a lack of enthusiasm for the discount rate change even though action is taken at the next regular meeting, since a special session could have been called. If a regular meeting of the Reserve board (or when the board meets monthly, a date 14 days after the regular meeting) passes without the rate moving

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<sup>20</sup>Hobart C. Carr, "A Note on Regional Differences in Discount Rates," Journal of Finance, XV (March, 1960), p. 62.

<sup>21</sup>Ibid.

into conformity, the lag probably reflects a judgment that the move by the other Reserve bank or banks was premature or mistaken.<sup>22</sup>

The use of borrowed funds by member banks to avoid a legal reserve deficiency is intended to be a temporary supplement and not a substitute for a bank's adaptation of its own asset holdings to the communities supply of and demand for credit. Three different influences prevent member bank borrowings from departing too far from standard:<sup>23</sup>(1) the discount rate itself, (2) bank reluctance to borrow, and (3) administrative action by discounting officials.

The discount rate itself may be a deterrent against borrowing. Since the discount rate represents a cost which banks pay in relation to alternative sources of funds (namely, Federal Funds, selling assets, and drawing down balances with and borrowing from correspondent banks), if the rate is higher than short-term market rates, the idea of borrowing will likely be discredited. As such, the most relevant comparison of the discount rate as a deterrent is with the costs of alternative sources of funds available. A false notion in relation to this is that the discount rate discourages member bank borrowing and that this leads to a tightening of bank lending operations. This idea is refuted by the fact that discount rates are generally at the low spectrum of

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<sup>22</sup>Ibid., p. 63.

<sup>23</sup>The Federal Reserve and the Treasury, op. cit., pp. 129-133.

interest rates.<sup>24</sup>

Reluctance toward borrowing prevents some member banks from utilizing the discount mechanism. The soundness of borrowing is questioned by some bankers. The bank's board of directors or larger depositors may consider discount use unfavorable. An avoidance of indebtedness over extended periods of time other than absolutely necessary reduces use of the discount mechanism. Some bankers are sensitive to inquiries by the Federal Reserve discount officials concerning their borrowing, and, as such, they avoid it.

Administrative action by the Federal Reserve discount officials can prevent member banks from borrowing. If the Federal Reserve, through its continuous appraisal of member bank portfolios, finds that they are using Federal Reserve credit for other than temporary, seasonal, or emergency needs, action is taken as to why. Federal Reserve policing action directly involves only a minority of borrowing banks. However, the effect of any administrative contact seems likely to continue for some time and spread beyond the particular member bank involved. A major problem in policing is that of communication--the conveying of a correct and uniform understanding of the usage of the discount mechanism. When the discount window was revived in 1955, the Fed considered it necessary to re-educate member bankers on the use of the

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<sup>24</sup>Paul S. Nadler, "What Does the Discount Rate Really Do?" Banking, LVIII (June, 1966), p. 34.

discount mechanism. Lastly, there is a tendency for bankers to be somewhat optimistic as to the likely duration of unexpected reserve drains. As such, the member banks may be slow in adjusting.



## CHAPTER III

### THE FEDERAL RESERVE SYSTEM'S USE OF THE DISCOUNT RATE

Primarily, discount rate changes are designed to keep them in line with short-term market rates--those rates on short-term liquid securities ranging from the shortest Treasury bills to Government and other securities of somewhat longer maturity that banks hold as secondary reserves.<sup>25</sup> Discount rate changes are also considered by the Fed as a signal of present and future intentions in regard to monetary policy. International monetary conditions also affect Fed's changing of the discount rate. Before these subjects may be effectively discussed, an understanding of the member bank's relation with the discount rate is needed.

A member bank's decision as to the most desirable way for it to make an immediate adjustment in its reserve position is affected by the level of the discount rate in relation to market rates of interest. The cost of adjusting a reserve position by borrowing is the interest charge incurred. This cost is measured by the interest earnings sacrificed when it sells securities to acquire funds. As such, a bank's preference of the alternatives available to acquire funds is greatly influenced by their cost. In considering the cost, the relation

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<sup>25</sup>The Federal Reserve and the Treasury, op. cit., p. 121.

of the discount rate to the cost of borrowing from banks (the Federal Funds market) and to market yields on Treasury bills and other securities held as liquid assets or as secondary reserves.

The movement of the discount rate is closely related to the movement of short-term market interest rates.<sup>26</sup> When credit demands expand strongly, short-term market rates tend to rise. This is caused by member banks selling Treasury bills and other readily marketable paper to obtain funds to meet rapid loan expansion. If short-term market rates rise above the discount rates, member banks have a greater tendency to borrow at Reserve Banks because it is less costly in adjusting their reserve positions. However, the Fed, through the Reserve Banks, is then likely to raise the discount rate in order to keep the discount mechanism functioning as a deterrent to unduly rapid expansion of bank credit. Failure to raise the discount rate in line with market rates would encourage and enlarge member bank use of the discount window. However, if the discount rate is raised above market rates, member banks will sell Government securities to the Fed to satisfy reserve requirements because of less cost. These sales tend to drive short-term interest rates up to or above the discount rate because they increase the market supply of short-term securities relative to demand.

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<sup>26</sup>The Federal Reserve System-Purposes and Functions, op. cit., pp. 47-49.

Therefore, in a period of strong credit demands, short-term market rates and the discount rate are likely to rise congruently until the demand pressures subside.

Numerous influences affect the timing and extent of discount rate changes by the Fed. As mentioned, discount rates will be increased when they are lagging behind market rates in order to keep the discount window under control and to maintain a discipline of indebtedness on member banks. Since discount rates which are higher than market rates will encourage repayment of existing debt to the Reserve banks, a rise may reflect this fact. Sometimes balance-of-payments considerations affect the timing and extent of discount rate changes; since discount rates deal with short-term market rates, they have an impact on international short-term capital movements.<sup>27</sup> If short-term market rates fall below discount rates in times of easing credit and less pressing loan demands, discount rates would likely be lowered to short-term rate levels. In this situation, discount rates would be lowered in order to reduce member banks' incentive to repay Reserve banks. This would encourage banks to utilize a greater portion of their reserves to expand loans and investments.

The discount rate has, at times, remained high or low relative to market rates for a long period. This phenomenon

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<sup>27</sup>The Federal Reserve and the Treasury, op. cit., p. 123.

results either because the frequency of Treasury financing has left few opportunities at the time discount rates could be conveniently altered, or because market rates may have been considered to be under transitory forces and expected to return closer to earlier levels and to the discount rate. During recession and monetary ease, a discount rate as low as market rates might not be considered necessary because at this time discount rate changes have little effect on banking actions.<sup>28</sup>

The discount rate is sometimes raised for technical reasons; to keep it in line with money market rates elsewhere.<sup>29</sup> This is done so that member banks are not overly tempted to try to borrow when they should be meeting reserve stringencies by reducing secondary reserves. Such stringencies occur when member banks lend aggressively and must borrow for this reason rather than through unanticipated fund outflows.

Discount rates may be changed by the Fed to signal to the public a change in, or reinforcement of, the prevailing Federal Reserve credit and monetary policy. When the Fed raises the discount rate, it indicates that credit policy either has been tightening or will soon tighten. A reduction of the discount rate proclaims that a period of greater

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<sup>28</sup>Ibid.

<sup>29</sup>Nadler, op. cit., p. 35.

credit ease and lessened restraint will be prevalent.

Although discount rates may be increased by the Fed with the purpose of signalling monetary intentions, adjustments, through their own nature, accomplish this purpose. However, perhaps the greatest significance from a discount rate change is in signalling Fed's present and future intentions.

There is a general understanding that when the discount rate is raised, interest rates are likely to rise generally throughout the economy. When discount rates fall, the reverse is considered to happen. The notion often held is that when the discount rate rises, it costs member banks more to borrow from the Fed, thus banks have to offset the higher cost through higher bank rates, and these higher rates in turn with the borrowing and spending of the general public. However, it is the Federal Reserve's open market operations which accompany the discount rate change that alters the state of the money market.<sup>30</sup>

When the Fed raises the discount rate, open market operations supplement the change to produce the desired result of the move. With the discount rate increase, sales of Government securities absorb reserves from member banks and lessen the availability of credit. This, in turn, makes credit tighter and makes it more difficult to borrow. When the discount rate is lowered, open market operations consist of purchasing securities. This action brings about the easing

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<sup>30</sup>Ibid.

of credit availability rather than the discount rate change itself. The lowering of the discount rate in this instance simply signals Fed's easy policy since there is usually little impact on the economy through the lowered rate.

Although interest rates than banks charge usually move in the same direction as discount rates, the result isn't due solely to the discount rate change. It reflects the expectation of the financial community that the availability of credit is being altered by the Fed and that basic supply and demand forces will bring about the change in interest rates that the Fed is signalling. The greatly fluid financial markets react to the expected future conditions immediately. Thus, banks often change their lending rates as soon as the discount rate is altered.<sup>31</sup>

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<sup>31</sup>Nadler, op. cit., p. 35.

## CHAPTER IV

### FEDERAL RESERVE DISCOUNT RATE CHANGES: 1951-1965

The importance of the discount rate mechanism was greatly increased by the Treasury-Federal Reserve Accord on March 3, 1951.<sup>31</sup> The Accord provided that the prices of Government securities were to be no longer "pegged" by open market actions; that short-term Government securities would be allowed to fluctuate more than in the past, around the discount rate. The practice of acquiring loanable funds by selling Government securities at a profit was eliminated. The Accord moved that securities could only be sold at a discount thus causing banks to become more reluctant to take book losses on Government sales in order to make loans. As such, the discount window began to look more and more attractive to member banks. Toward the end of 1952, member bank borrowings from the Fed had climbed to over \$1.5 billion from \$242 million in March, 1951. Another stipulation of the Accord was that the discount rate would remain at 1 3/4% for the remainder of 1951. The Accord, then, re-affirmed the Federal Reserve System's purpose, that is to conduct flexible

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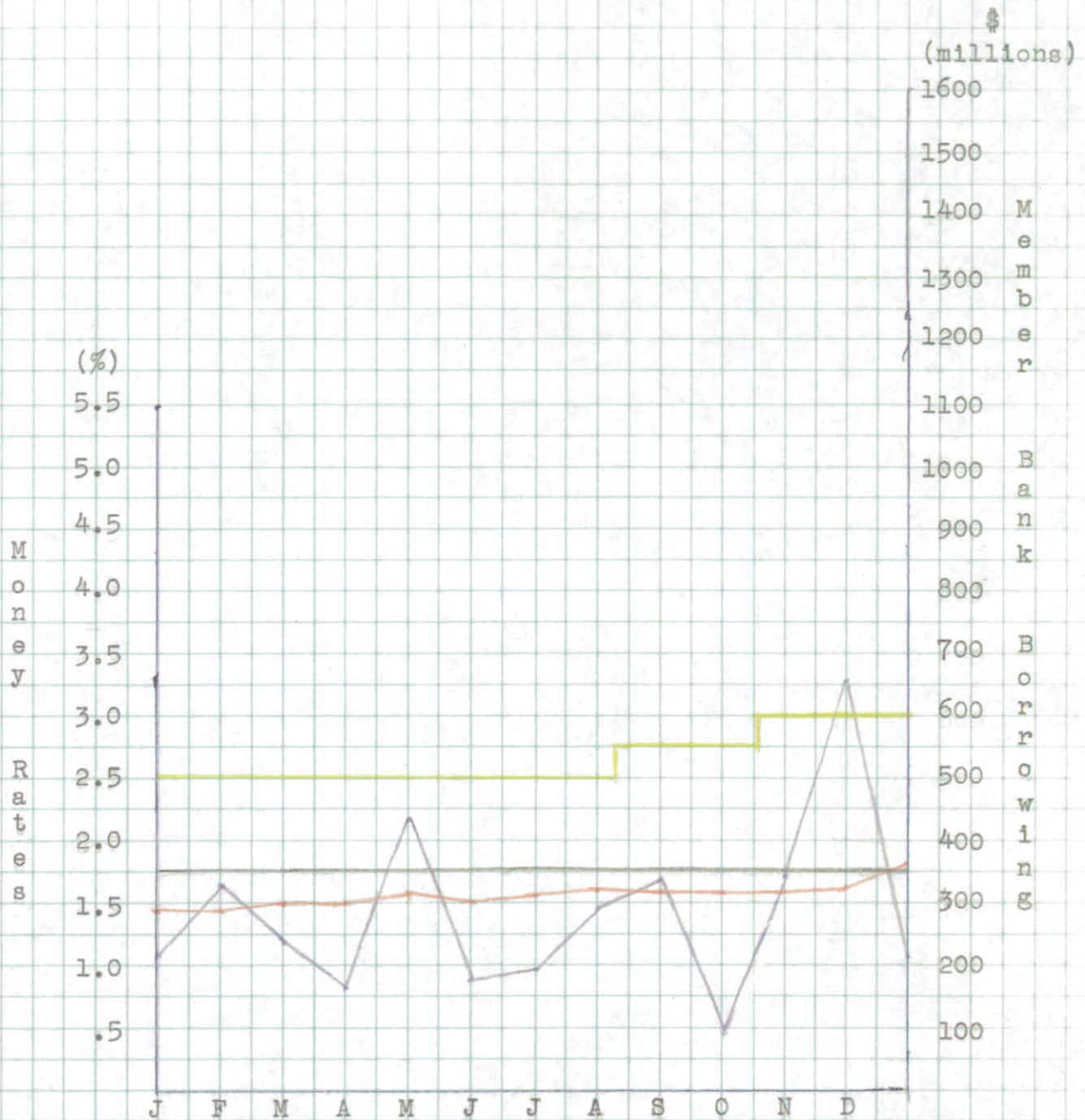
<sup>31</sup>George W. McKinney, Jr., The Federal Reserve Discount Window, (New Brunswick: Rutgers University Press, 1960), p. 22.

NOTE: All figures of discount rates, money market rates, and member bank borrowings in this paper were obtained from various issues of the Federal Reserve Bulletin.

CHART I

1951

27



- Three month Treasury bills (Monthly Average)
- Discount rate
- Prime rate
- Member bank borrowing (Monthly Average)

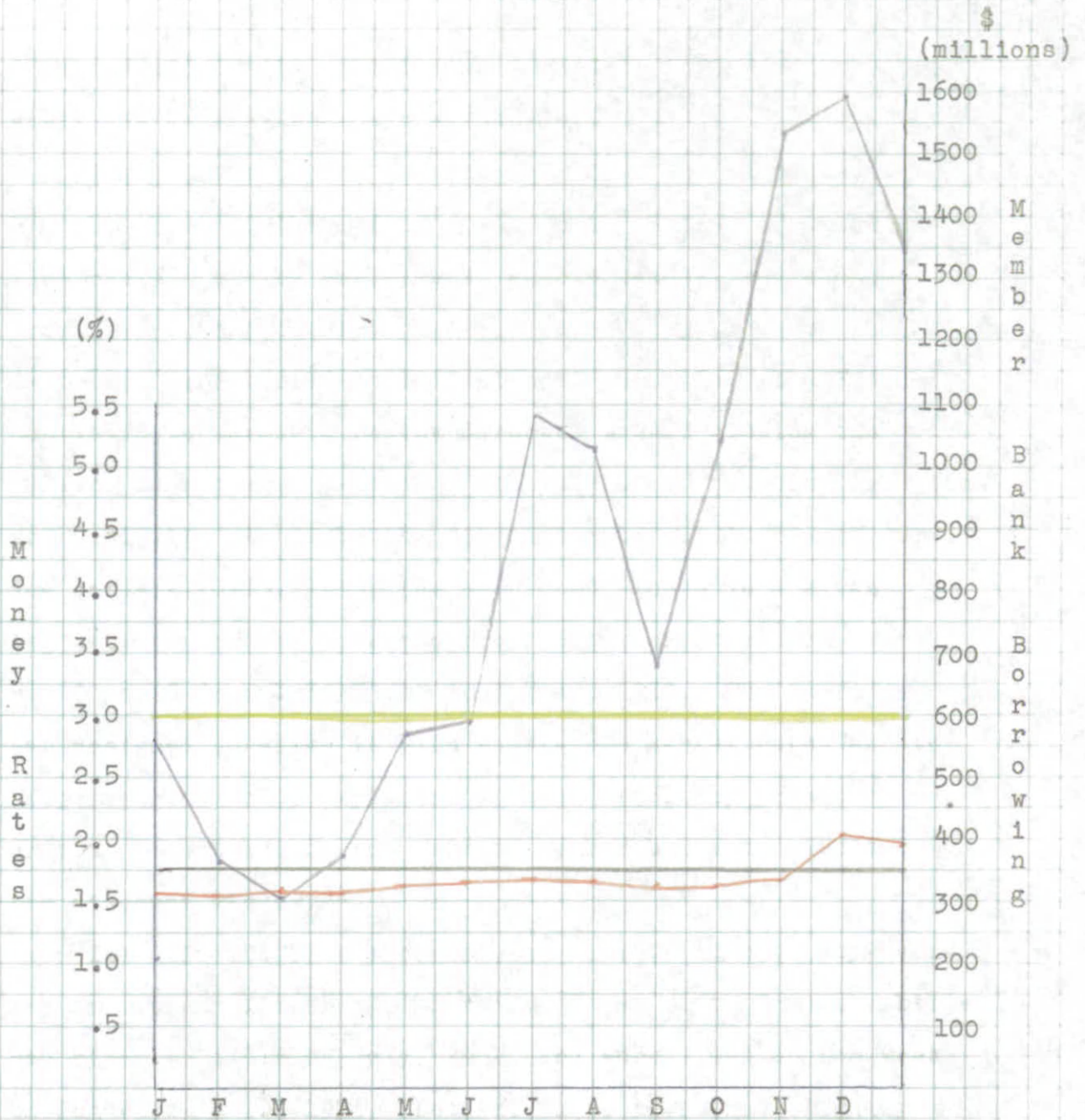
NOTE: All figures were compiled from various issues of the Federal Reserve Bulletin.



CHART II

1952

28



- Three month Treasury bills (Monthly Average)
- Discount rate
- Prime rate
- Member bank borrowing (Monthly Average)

NOTE: All data is from various issues of the Federal Reserve Bulletin.

monetary and credit policies as needed to influence appropriately the general economic situation.

The first discount rate change after the Accord was brought about at the end of a six month plateau of the 1950-1954 cycle. Rising employment, stable values, and economic growth were characteristic at the end of 1952. Since the expansion represented an inflationary potential, the Fed continued to pursue a policy directed toward slowing the pace of bank credit expansion with a goal of reducing inflationary activity. As such, the discount rate was increased during January 16-23, 1953, (as mentioned, there is a slight lag between Reserve Bank adoption of the uniform discount rate) to 2% from 1 3/4% set in August, 1950. The increase was designed to align it with short-term market rates and to help restrict undue expansion in bank credit by promoting greater reluctance on the part of member banks to resort to the discount window.<sup>32</sup>

The discount rate increase was too late to have any meaning as a control measure, however. Three month Treasury bills had risen to 1.81% by July, 1952, and were 1.99% on the week ending January 10, 1953. Federal Funds rates had slightly surpassed the previous 1 3/4% discount rate in late December

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<sup>32</sup>Eastburn, op. cit., p. 82.

and early January. The initial effect of the discount rate, however, was a stricter attitude toward member bank borrowing on the part of Federal Reserve bank loan officers. This attitude is considered to have brought about the borrowing reduction, not the rate change itself.<sup>33</sup>

In addition to the discount rate change, the Fed used another weapon. In February, 1953, margin requirements on loans for purchasing and carrying listed securities were reduced from 75% to 50% of market value. The Fed wanted to lower the requirement that would be adequate to prevent excessive use of credit for purchasing and carrying stocks. Also, between January and April, 1953, the Fed open market committee sold and redeemed \$800 million of United States Government securities to offset seasonal changes affecting member bank reserves and to maintain pressure on these reserve positions.<sup>34</sup>

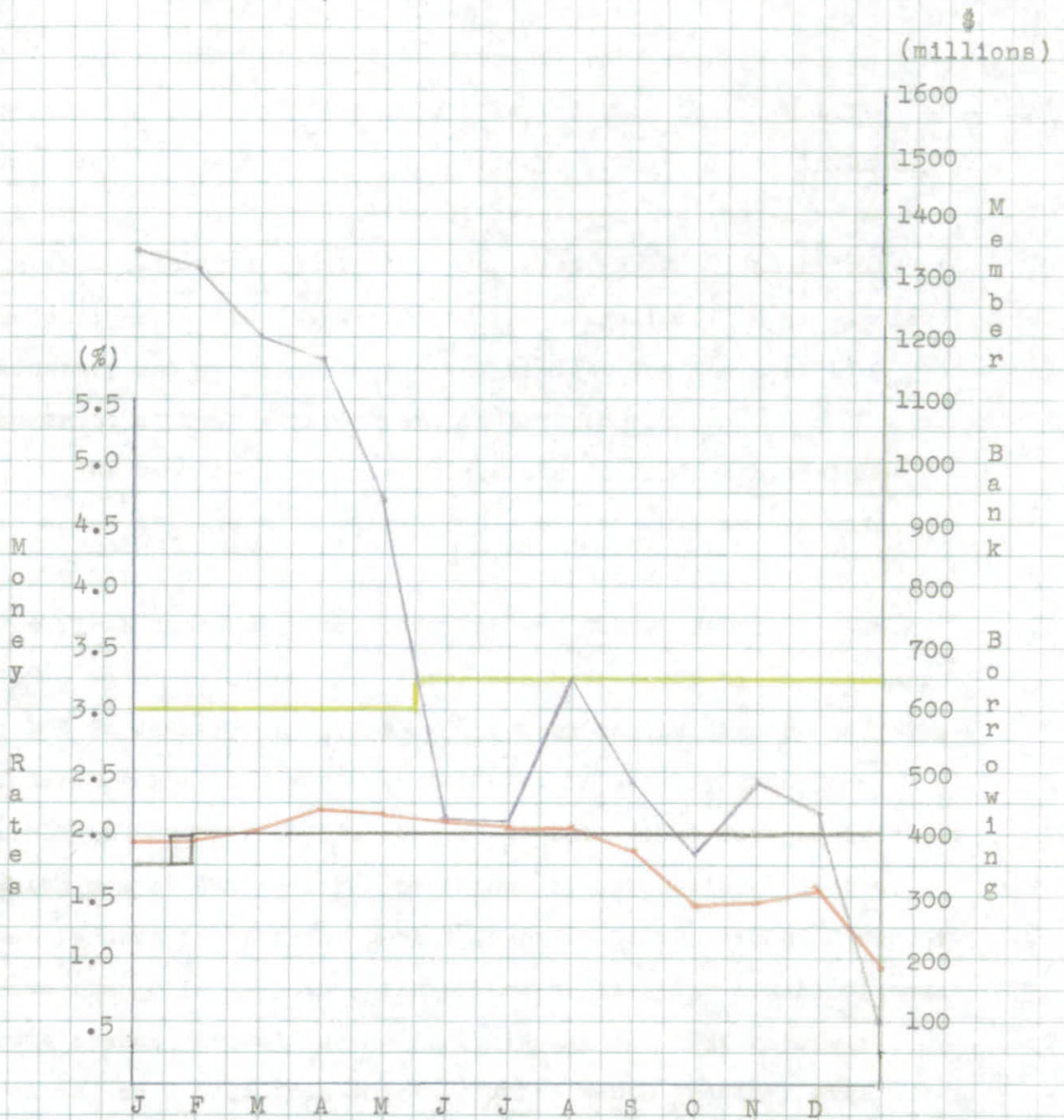
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<sup>33</sup>Knipe, op. cit., p. 285.

<sup>34</sup>Eastburn, op. cit., p. 81.

NOTE: After each discussion of a change in the discount rate, a chart will follow illustrating money market rates, the discount rate, and member bank borrowing for the year of the discount rate adjustment.

1953



- Three month Treasury bills (Monthly Average)
- Discount rate and adjustment period
- Prime rate
- Member bank borrowing (Monthly Average)

NOTE: All data is from various issues of the Federal Reserve Bulletin.

The context of the 1954 discount rate changes was in a relatively mild recession. The contraction lasted until August, 1954. The recession was due, primarily, to inventory in that general defense expenditures declined whereas non-inventory investment didn't.<sup>35</sup> The ensuing Fed discount rate reductions in the first half of the year signalled an easier monetary and credit policy aimed at lowering the cost of money to stimulate investment in inventory.

The two discount rate reductions in 1954 were designed to align it closer to market rates of interest and to eliminate any undue deterrent to bank borrowing from the Fed.<sup>36</sup> The first discount rate reduction was during February 5-15, 1954, to 1 3/4% from 2%. Three month Treasury bills averaged 1.18% in January and 1.01% on the week ending January 30. The Federal Funds rate was down to 0.78% in January down from 1.81% in November, 1953. The prime rate (that rate of interest which member banks charge customers of unquestioned credit) was reduced to 3% from 3.25% just prior to the second discount rate change in 1954 in anticipation of it. The second discount rate change occurred during April 14-May 21. The rate was reduced to 1 1/2% from 1 3/4%. Three month Treasury bill yields averaged 1.03% in March and 1.00% on the week ending

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<sup>35</sup>Gordon, op. cit., p. 489.

<sup>36</sup>Eastburn, op. cit., p. 82.

April 10. Before uniformity in the discount rate was reached, Treasury bill rates had dropped to .75% on the week ending May 15 from .96% in April. The Federal Funds rate dropped from 1.56% in February to .75% in May. Member bank borrowing increased by nearly \$200 million in February over the January average, but slowly decreased and remained relatively constant. (See page 34)

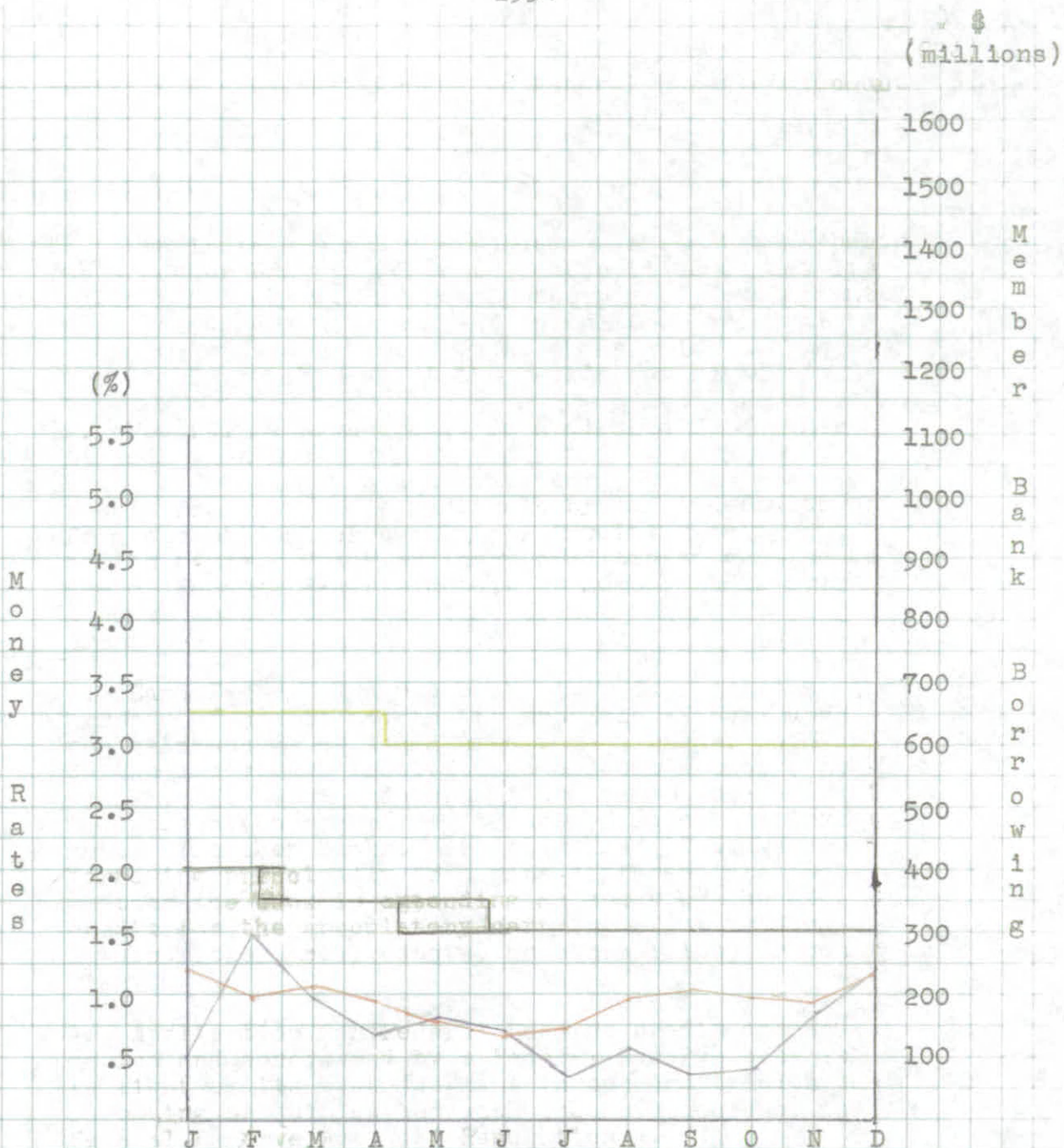
Other Fed countercyclical mechanisms coordinated with the manipulation of the discount rate. Buying rates on 90-day bankers' acceptances were reduced from 2 1/8% to 1 3/4% in February and to 1 1/2% in April-May. The Fed reasoning here is the same as discount rate reduction reasoning. Also, open market operations produced a net sales of about \$900 million of United States Government securities between January and June. These sales were to absorb part of the reserves made available by seasonal deposit contraction and to return the flow of currency thereby further easing bank reserve positions.<sup>37</sup>

The importance of the discount rate mechanism as a countercyclical monetary tool was emphasized in January, 1955, by a Federal Reserve revision of Regulation A, that which deals with advances and discounts. The revision condoned and promoted the idea of the discount rate mechanism.

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<sup>37</sup> Ibid.

1954



- Three month Treasury bills (Monthly Average)
- Discount rate
- Discount rate adjustment period
- Prime rate
- Member bank borrowing (Monthly Average)

NOTE: All data is from various issues of the Federal Reserve Bulletin.

The revision stated that access to Federal Reserve discount facilities is granted as a privilege of membership to the Federal Reserve in light of the following principles:<sup>38</sup>

"1. Credit is generally extended on a short-term basis to a member bank in order to enable it to adjust its asset position when necessary because of developments such as sudden withdrawal of deposits or seasonal requirements for credit beyond those which can be reasonably met by use of the bank's own resources.

2. Federal Reserve credit is available for longer periods when necessary in order to assist member banks in meeting unusual situations, such as may result from national, regional, or local defaults or from exceptional circumstances involving only part of the banks. Under ordinary conditions, continuous use of Federal Reserve credit by member banks over a considerate period of time is not regarded as appropriate.

3. Each Federal Reserve bank gives due regard to the purpose of credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institutions and the economy, generally. It keeps informed of and takes into account the general character and amount of loans and investments of member banks. It determines if banks are borrowing principally from rate differentials and whether the bank is extending an undue amount of credit for the speculative carrying of or trading in securities, real estate, or commodities, or otherwise.

4. Application for Federal Reserve credit accommodation and considered by a Federal Reserve bank is in light of its best judgment in conformity with the foregoing principles and with the provisions of the Federal Reserve Act and Regulation A."

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<sup>38</sup>Federal Reserve Bulletin, XLI (January, 1955), pp. 8-14.



In 1955, the economic situation was that of the beginning of the 1955-1957 durable goods boom. This upswing was unique. First, it was the first post-war expansion not directly related to war, it was concentrated in the durable goods industries, and unemployment did not fall below four percent. The rapid rise in prices and the vigorous investment boom led monetary authorities to follow a restrictive monetary policy, while the slow growth in output after 1955 and the existence of pockets of unemployment led many observers to advocate a policy of monetary ease.<sup>39</sup>

As such, 1955 was an active year for discount rate adjustments. The first discount rate change was an increase during April 14-May 2 to 1 3/4% from 1 1/2%. Since the economy was in the eighth month of the expansionary upswing and Fed policy had been greatly restraining through the eight months, the increase couldn't be regarded as a signal. The rate was, primarily, raised to align it with open-market money rates and to make borrowing by banks more expensive.<sup>40</sup> Three month Treasury bills averaged 1.28% in March and were 1.49% on the week ending April 9. During the adoption of the discount rate by member banks, bill rates rose to 1.63% on the week ending April 16, to 1.65% on the week ending April

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<sup>39</sup>Gordon, op. cit., p. 493.

<sup>40</sup>Knipe, op. cit., p. 285.

23, and down to 1.62% on the week ending April 30. The Federal Funds rate was 1.42% in early April and 1.69% in May. In conjunction with the discount rate increase, margin requirements on loans for purchasing or carrying listed securities were increased from 60% to 70% of market value. The Fed wanted to help prevent an excessive use of credit for purchasing or carrying securities in a period of increasing use of credit for carrying securities.<sup>41</sup>

As the upswing continued, the Fed applied restrictive policies more firmly. Discount rates were increased from 1 3/4% to 2 1/4% from August 4 to September 13 and to 2 1/2% during November 18-23. The Fed wanted to keep the discount rate in appropriate relationship with market rates of interest to maintain a deterrent on excessive borrowing by member banks at the Reserve banks.<sup>42</sup> Three month Treasury bills averaged 1.60% in July and increased to 2.07% on the week ending November 19. Federal Funds rates averaged 1.92% in July and 2.85% in November. Insofar as the discount raises in August and November had any value in confirming a restrictive Fed policy of long standing, it was somewhat dissipated in the confusion of the August-September raises. The Cleveland Reserve Bank increased its rate from 1 3/4% to 2 1/4% in

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<sup>41</sup>Eastburn, op. cit., p. 83.

<sup>42</sup>Ibid., p. 85.

August while the remainder went only to 2%. In September, the other eleven Reserve banks increased their discount rates to Cleveland's 2 1/4%. This disparity reduced any effect of a signal intention by the Fed.

Repercussions on the money market after the November 18-23 discount rate increase were extensive. Three month Treasury bills rose to 2.44% in mid-November, the highest in 25 years. The price of Government bonds dropped sharply. Member banks raised interest rates on loans to brokers and security dealers from 3 1/2% to 3 1/4%. Commercial paper dealers and major finance companies boosted by 1/8 point the interest they charged on short-term loans.<sup>43</sup> Federal funds were quoted at over 2.5% which indicated that tightness was prevalent throughout the banking system and the major finance companies raised rates by 1/4%, the seventh such increase of 1955.<sup>44</sup> Prime rates rose to 3 1/4% from 3% on August 4, and to 3 1/2% on October 14.<sup>45</sup> After the November discount rate, there was an indication of another increase, but it never materialized.

The Federal Reserve Board wanted the money market to

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<sup>43</sup>"Another Push on the Brakes," Business Week, (November 26, 1955), p. 25.

<sup>44</sup>"Bank Loans Will Cost More," Business Week, (September 3, 1955), p. 32.

<sup>45</sup>"Another Push on the Brakes," op. cit., p. 25.

tighten to slow down the economy. The Fed denied a charge that it was trying to halt borrowing. It said that it didn't intend to halt legitimate borrowing, but it did intend to control the supply of credit by keeping reins on the prevailing expansion and to hold prices in check.<sup>46</sup> Since member banks were borrowing more freely (See page 40), and liking it, the Fed wanted to put a limit on this by slightly penalizing this activity.

During 1955, Federal Reserve open market operations were actively combating inflation. Between March and December, open market operations made net purchases of bankers' acceptances totaling \$28 million to recognize the increased use of them by business as a means of financing international trade. Between July and December, the Fed made outright purchases of Treasury bills totaling \$700 million net to aid member banks in meeting reserve needs of seasonal nature and further increasing indebtedness. The Fed also purchased new Treasury certificates of indebtedness of \$167 million during November and December to supply reserves and to be consistent with the prevailing open market policy.<sup>47</sup>

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<sup>46</sup> Ibid., p. 26.

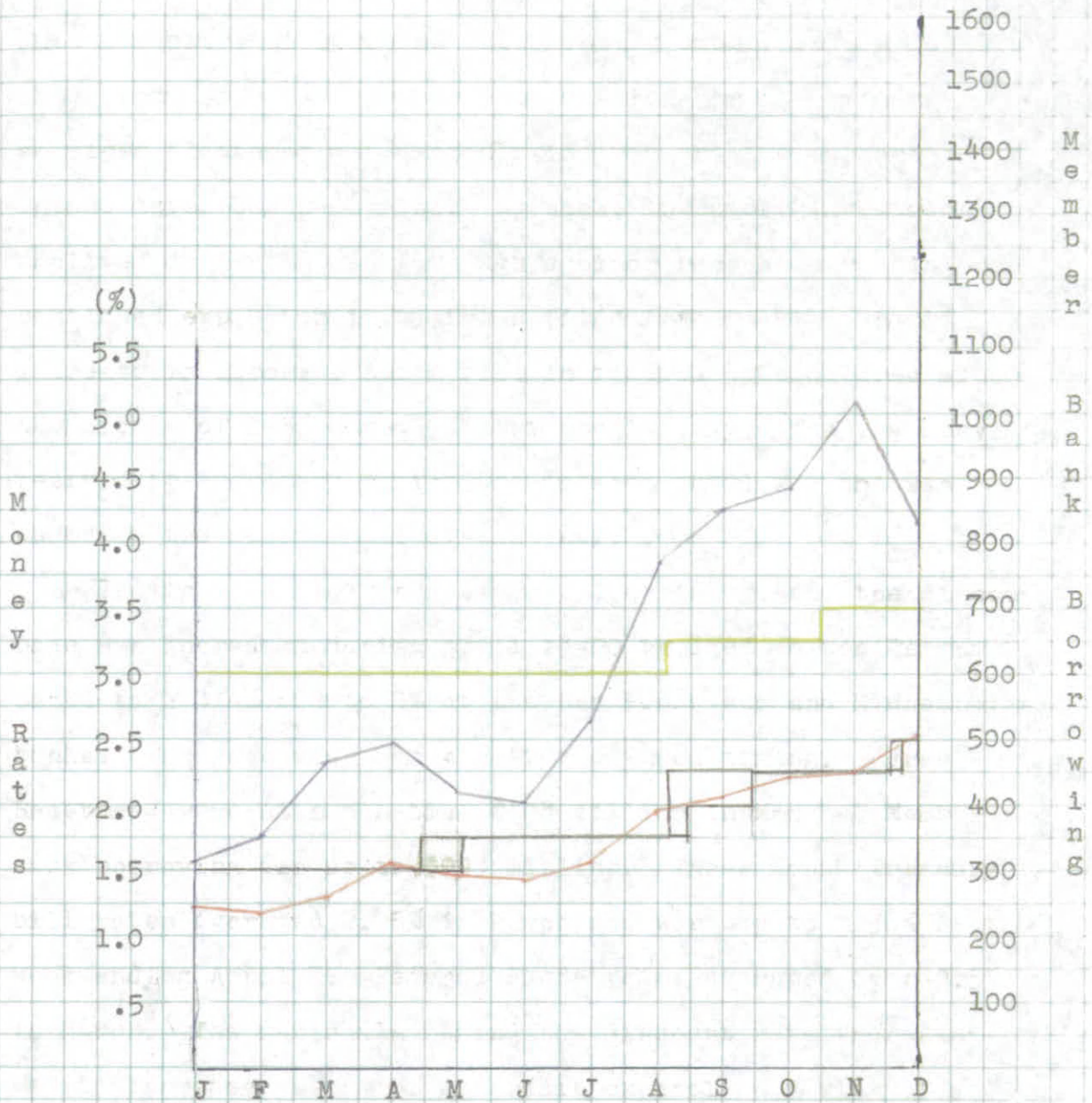
<sup>47</sup> Eastburn, op. cit., p. 84.

CHART V

40

1955

(Millions)



- Three month Treasury bills (Monthly Average)
- Discount rate and adjustment period
- Prime rate
- Member bank borrowing (Monthly Average)

NOTE: All data is from various issues of the Federal Reserve Bulletin.

By the beginning of 1956, the economy was operating to full capacity, with demand outstripping supply in the durable goods industries. Consumer expenditures for other than services flattened out markedly in 1956 and the proportion of income saved began to rise. As such, inventory investment declined during 1956. Although a minor recession was in order, continued expansion in business fixed investment, a rapid increase in exports, and a rise in federal expenditures after the middle of 1956 combated that possibility.<sup>48</sup> Thus, a heavily restrictive monetary policy was imposed until May and was eased in the second half of the year.

In light of the restrictive policy in effect, the discount rate was increased during April 13-20 by 1/4% at ten Reserve banks to 2 3/4% and to 3% at the San Francisco and Minneapolis banks. The rate rise was a matter of good timing. "Free Reserves" were at a negative \$408 million in March. Member bank borrowing was up to \$993 million. Three month Treasury bill rates averaged 2.25% in March and were up to 2.38% on the week ending April 7. Federal Funds rates averaged over 2.5% in March. The rationale behind the discount rate increase was to increase restraint on credit expansion in view of a sharp increase in bank credit in March and indications of broad increases in spending, growing demands for credit, and

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<sup>48</sup>Gordon, op. cit., p. 495.

upward pressures on prices and costs.<sup>49</sup>

Up to this point, the prevailing restrictive monetary policy had not evoked public opposition. However, with the granting of San Francisco and Minneapolis a 1/4% higher discount rate, the Fed found itself in a quandary. This conspicuous action was taken at a time when the business situation had been developing a few signs of weakness and the production total had leveled off for several months. Instead of keeping quiet and assessing the situation more thoroughly, the Fed acted on the rate in a way that suggested that all twelve banks felt more restraint was needed but two felt that much more was needed. The press, to which the Fed said nothing, just announced the actions. The Fed, for its own record, commented that the raise "also served as a signal to those businesses planning to finance plant and equipment expansion through the capital markets that higher borrowing costs might be anticipated if the supply of savings was taxed further by demands for capital."<sup>50</sup>

Partly due to the furor which arose after the April move, the Fed instituted an easing policy which lasted from May, 1956, through January, 1957. However, the other discount rate change in 1956 was an increase during August 24-31 when the Fed approved raises of 1/4% to the ten banks which were not

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<sup>49</sup>Eastburn, op. cit., p. 85.

<sup>50</sup>Knipe, op. cit., pp. 286-287.

already at 3%. The rationale was to move the discount rate in conformity with rises in market rates resulting from vigorous credit demands. Three month Treasury bills averaged 2.31% in July and increased to 2.64% on the week ending August 18. Federal Funds rates averaged 2.81% in July. Also, the Fed wanted to signal the financial and business community and the public the need for credit restraint and for resistance to inflationary developments.<sup>51</sup> In light of an easing action by the Fed, however, this increase was puzzling.

Perhaps, the prime objective of the August rate increase was to limit the supply of funds so that credit would become tighter, excluding meeting seasonal needs.<sup>52</sup> The Fed hoped that the new raise would cool the demand for credit and thus keep the economy from indulging in a speculative inflationary outburst. If the Fed supplied all the credit that the business and consumer wanted, an all out inflation would be incited, due to the fact that money was exceeding need due partly to the end of the steel strikes, which was bringing about a wave of inventory accumulation. Since the Fed didn't want lenders to give into the pleas of borrowers, the prime rate was increased from 3 3/4% to 4% in anticipation of tighter money due to the proposed discount rate increase in August.

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<sup>51</sup>Knipe, op. cit., p. 287.

<sup>52</sup>"Banks Leap in to Raise Money Rates," Business Week, (August 25, 1956), pp. 30-31.



Open market operations again complemented discount rate changes in 1956. During April and May, open market operations included sales of Government securities of \$350 million to supplement the April discount rate increase. The move was made to increase restraint on credit expansion. During August and November, Fed open market operations purchased nearly \$1 billion of Government securities.<sup>53</sup> This action was taken during the August discount rate increase. In this instance, open market operations seemed to be in opposition rather than supplementary to the discount rate change. Since open market operations usually consist of sales of Government securities during a discount rate increase to tighten credit, the August-November action seemed out of place. However, since the Fed was adopting an easing monetary policy, the open market operations were to supply member banks with reserves since the discount rate was only trying to match short-term market rates.

The 1956 discount rate increases may be said to have begun a new evolution of the importance of it as a signal of Federal Reserve intentions. Since member banks actively resumed the pre-depression practice of borrowing, the discount rate became a major control weapon which the Fed chose to exploit. A cardinal point in Federal Reserve doctrine is that the value of member bank borrowing is the decisive factor in determining

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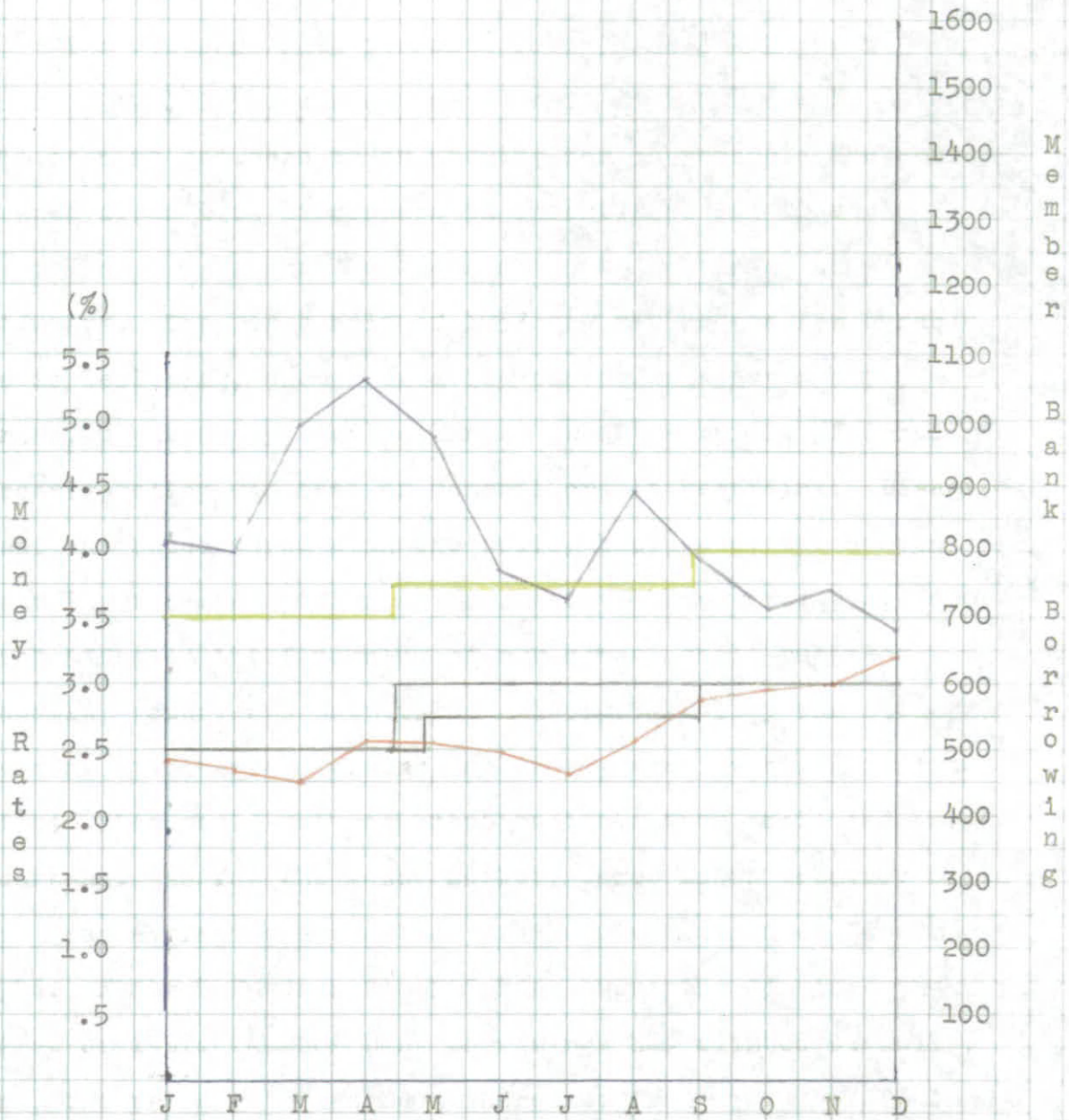
<sup>53</sup>Eastburn, op. cit., p. 85.

CHART VI

1956

45

(millions)



- Three month Treasury bills (Monthly Average)
- Discount rate and adjustment period
- Prime rate
- Member bank borrowing (Monthly Average)

NOTE: All data is from various issues of the Federal Reserve Bulletin.

the condition of the money market.<sup>54</sup>

The discount rate increase from 3% to 3 1/2% during August 9-23, 1957, was a timing error by the Fed. By August, the economy had been in an upswing for 36 months. The economy seemed tired with imbalances in inventories and plant and equipment and general business activity continued to move sideways. The first half of 1957 saw new orders for durable goods declining, excess capacity curtailing investment programs, tight money, and declining profit margins.<sup>55</sup> Federal Reserve policy was that of general credit restraint. Disagreement was encountered with the policy because of the uneven effects it had on different prospective borrowers; e.g. funds lack affected the financing of new homes, small business, schools, roads, and hospitals. Also, the policy was attacked because it diverted lending to lending and investing institutions which could get permanent business from small and large business. As for the money market, three month Treasury bills had been averaging above the 3% discount rate since December, 1956. Federal Funds rates had been averaging 3% since the first of 1957. Member bank borrowings had climbed steadily. And, the prime rate had been increased from 4% to 4 1/2% in

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<sup>54</sup>Edward C. Simmons, "A Note on the Revision of Federal Reserve Discount Policy," XI (December, 1956), p. 413.

<sup>55</sup>Gordon, op. cit., pp. 496-497.

August in anticipation to a discount rate increase and tighter money. The discount rate increase which followed was the seventh consecutive increase of credit restrictions since April, 1955, and the 3 1/2% rate was the highest in 23 years.<sup>56</sup>

The rationale behind the discount rate increase, according to the Federal Reserve Board was to bring it in closer alignment with short-term money rates and to maintain a restrictive effect of member bank borrowing.<sup>57</sup> Undoubtedly, this reasoning must be taken in a different light considering the tremendous lag in adjustment to market rates. William McChesney Martin, Chairman of the Federal Reserve Board of Governors at that time and presently, said that strong inflationary pressures still existed. Thus, he was willing to see money get tighter if demand for credit kept on growing. "Restraint on the growth of credit is still required," according to Chairman Martin, "because inflation is clearly the most critical economic problem now facing this country."<sup>58</sup> The Fed thinking was that the economy would begin expansion with the removal of inflationary pressures and a greater-than-seasonal demand for credit.<sup>59</sup>

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<sup>56</sup>"New Discount Move Adds Heat To Tight Money Debate," Business Week, (August 17, 1957), p. 29.

<sup>57</sup>Eastburn, op. cit., p. 86.

<sup>58</sup>"New Discount Move Adds Heat To Tight Money Debate," op. cit., p. 30.

<sup>59</sup>Ibid.

The immediate down-turn of the economy after the discount rate increase in August couldn't be blamed entirely on it. It could be said that the Fed failed miserably in using the rate as an economic or public relations tool. The Board apparently saw the lack of finesse in its discount rate manipulation in that it tried to minimize the meaning of the rise, contrary to the basic use of the rate, a signal of Fed intentions. The New York Times on August 11, 1957, correctly defined the Fed's actions by stating, "Federal Reserve Board officials--- took pains to term the subsequent advance in the discount rate as routine and largely meaningless, a symbolic evidence of continued steady restraint. In recent years, they were careful to point out, changes in the discount rate more often followed changes in other market rates than led them."<sup>60</sup>

The other discount rate change in 1957 was considered as the first one which "said something to the world". Between November 15 and December 2, the Fed approved a discount reduction from the prevailing 3 1/2% to 3%. This move was considered by economic and financial experts as a model operation on the part of discount rate manipulation for the signalling of the Fed's intentions, a reversal of the previous tight credit and money policy. Although the Fed bowed to the Eisenhower Administration's pressure through concern of

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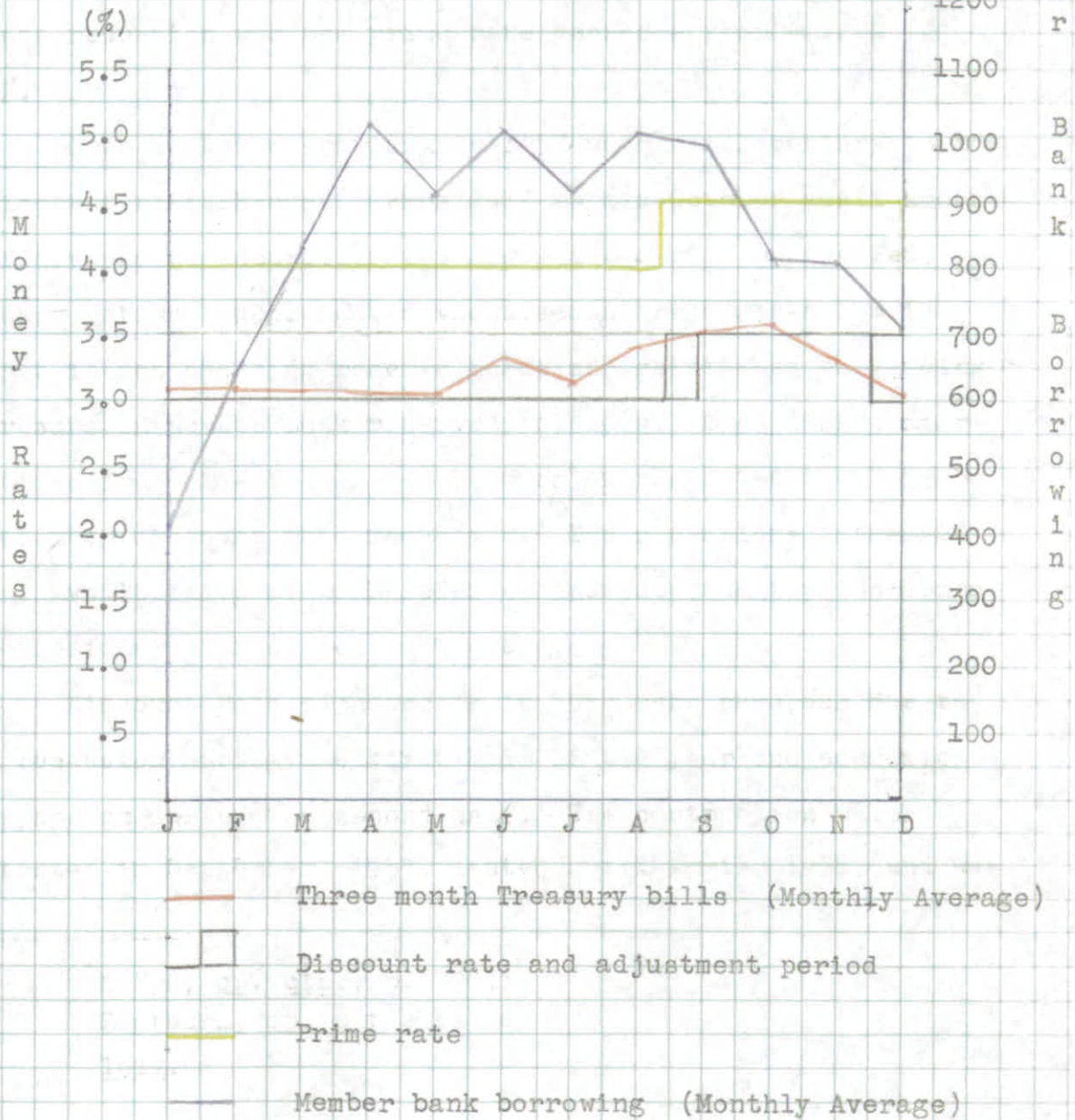
<sup>60</sup>Knipe, op. cit., p. 289.

CHART VII.

1957

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(millions)



NOTE: All data is from various issues of the Federal Reserve Bulletin.

a threat of business downturn, the Board still continued to emphasize inflationary dangers.<sup>61</sup> As such, the reduction was aimed to reduce the cost of borrowing from the Reserve banks and to eliminate any undue restraint on bank borrowing in view of the decline in business activity and evidences of economic recession.<sup>62</sup> An important outcome of the discount rate reduction was the prime rate decrease from 4 1/2% to 4%.

Open market operations in 1957 were complementary to the discount rate changes. From July to mid-October small amounts of Government securities were bought and sold by the Fed. These actions supplemented the discount rate mechanism in that it met changing reserve needs and maintained continuing pressure on member bank reserve positions. Open market operations from mid-October to December supplemented the November-December discount rate reduction. The operations increased the availability of bank reserves and subsequently cushioned recessionary tendencies in the economy.<sup>63</sup>

Discount rate adjustments in 1958 were numerous due to a recession during the first half of the year and economic expansion during the second half. The contraction which started in September, 1957, lasted until April, 1958, and was

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<sup>61</sup>Knipe, op. cit., p. 290.

<sup>62</sup>Eastburn, op. cit., p. 86.

<sup>63</sup>Ibid. . . .

one of the shortest contractions of the last century. However, the briefness of it was accompanied by extremity. Industrial production declined 13.7%, Gross National Product declined 4.7%, and unemployment was the most severe of the recessions experienced since World War II.<sup>64</sup> The recession was unique, however, in that prices continued to rise, contrary to typical recession price behavior.

As such, discount rates were reduced during the recession to lower the cost of borrowing from Reserve banks and to increase the availability of bank reserves in order to encourage credit and monetary expansion.<sup>65</sup> The first discount rate change during the recession was a reduction from 3% to 2 1/4% during January 22-March 21. The changes were made in a series of steps with San Francisco the last Reserve bank to conform. This lag blotted, somewhat, the effect of the reductions. Three month Treasury bill rates on the week ending January 18 dropped to 2.57% from the December, 1957, average of 3.04%. Federal Funds rates dropped from 2.18% in December, 1957, to 1.67% in January, 1958. The prime rate was reduced to 4% from 4 1/2% in January in anticipation of lowered discount rates. The January-March discount rate reduction was timely and signalled an extremely easy monetary policy in that reserve requirements were also reduced. In February, reserve

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<sup>64</sup>Gordon, op. cit., p. 497.

<sup>65</sup>Eastburn, op. cit., p. 87.



requirements on demand deposits were reduced to 19 1/2% from 20% central reserve city banks; to 17 1/2% from 18% at reserve city banks; and to 11 1/2% from 12% at country banks. This action freed \$500 million of reserves. In March, reserve requirements on demand deposits were again lowered to 19% at central reserve city banks; to 17% at reserve city banks; and to 11% at country banks. This move freed an additional \$500 million of reserves.<sup>67</sup> These actions further supplemented easy monetary policy in progress.

In April, another assault against the recession was waged by the Fed. The discount rate was reduced during April 18-March 9 to 1 3/4%. This change lagged behind the easy monetary and credit policy in effect since three month Treasury bills averaged 1.30% in March and were down to 1.10% on the week ending April 12. Federal Funds varied around 1.0% in March and the beginning of April. Reserve requirements on demand deposits were again reduced to 18% at central reserve city banks and to 16 1/2% at reserve city banks. This move freed an additional \$450 million of reserves.<sup>68</sup> A major reason for the use of two control mechanisms by the Fed in April was to get member banks to lower the prime rate, which they weren't anxious to do. Rather than lower the prime rate, they were cutting service charges, reducing the necessity of

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<sup>67</sup>Eastburn, op. cit., p. 87.

<sup>68</sup>Ibid.

maintaining a large compensatory deposit ratio, and arranging short-term loans for preferred customers through banker's acceptances, which then cost less than 2%.<sup>69</sup> However, the prime rate was reduced to 3 1/2% from 4% on the day of the discount rate change announcement.

In addition to the discount rate and reserve requirement reductions during the first half of 1958, open market operations encouraged bank credit and monetary expansion. Between and including February and June, nearly \$2.2 billion of United States Government securities were purchased by the Fed to supplement reserve requirement actions in further increasing availability of reserves.<sup>70</sup>

In retrospect, the extremity of Federal Reserve monetary and credit actions to combat the then prevailing recession was tremendous. The discount rate, during the first half of 1958, was reduced by 1 1/4% beginning with the well timed January reduction. Reduced reserve requirements between and including February and April released nearly \$1.5 billion of reserves. And, open market operations during the first half of the year increased member bank reserve positions by \$2.2 billion. With such concentrated Fed action, it is clear why the recession didn't last any longer than it did.

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<sup>69</sup>"Banks Follow the Fed's Lead," Business Week, (April 26, 1958), pp. 29-30.

<sup>70</sup>Eastburn, op. cit., pp. 87-88.

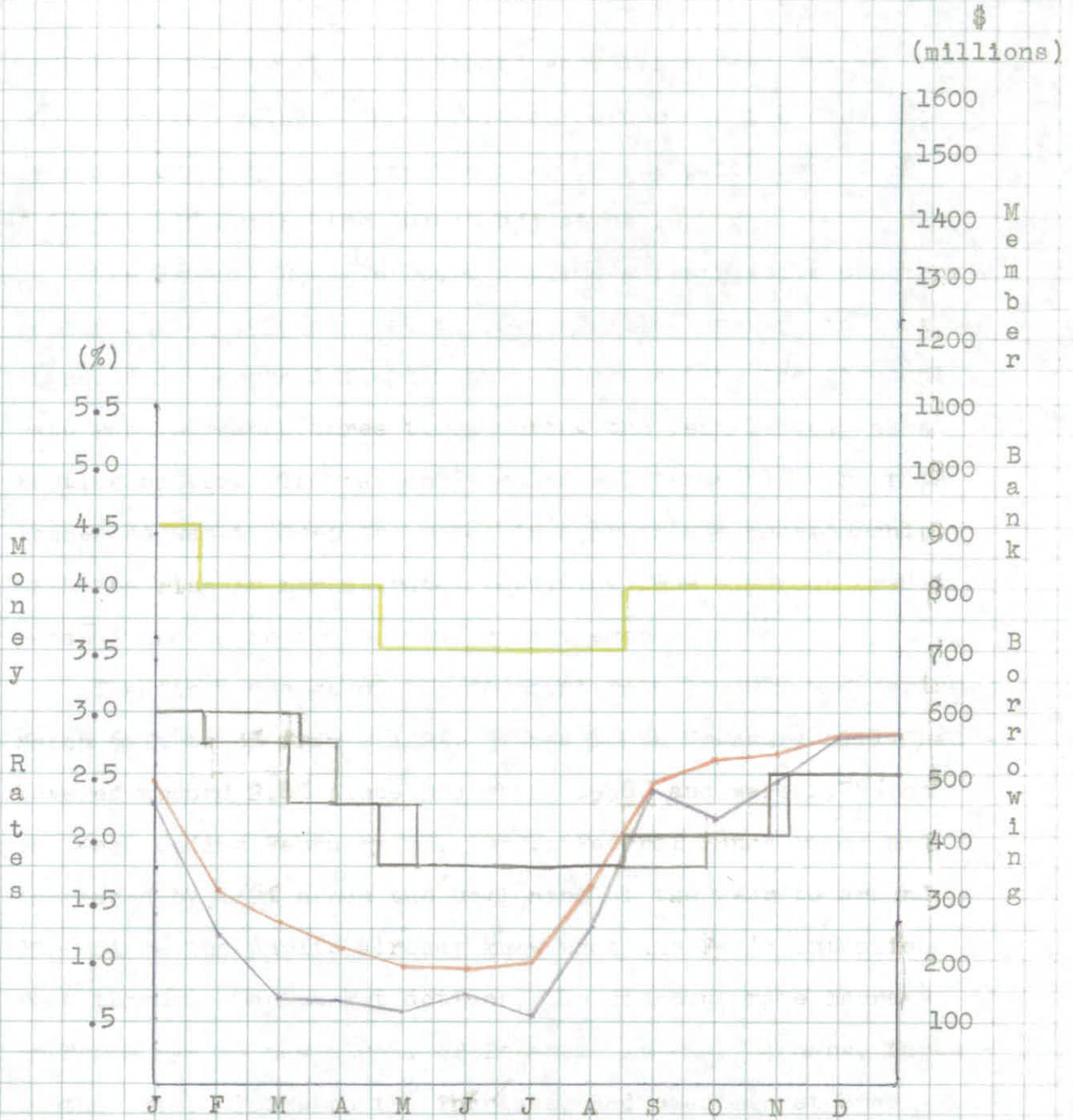
The upswing began in May, 1958. By August, it was in its fourth month. As such, monetary policy was reversed to a restrictive policy beginning with a discount rate increase from  $1\frac{3}{4}\%$  to  $2\%$  between August 15 and September 23. This increase was seemingly more congruent with the prevailing economic and monetary conditions than in the past and was more tuned to the climbing three-month Treasury bill rate which averaged  $.91\%$  in July and  $1.58\%$  on the week ending August 16. The Federal Funds rate had met the discount rate by August. Other than to keep the discount rate in an appropriate relationship with market rates, the action increased the cost of borrowing by member banks in case of increasing demands for bank credit. The last discount rate manipulation of 1958 was during October 24-November 7 with an increase of  $1/2\%$  to  $2\frac{1}{2}\%$ . The rationale behind this move was the same as the previous change. Three month Treasury bills had averaged  $2.44\%$  in September and  $2.67\%$  on the week ending October 18. The Federal Funds rate was averaging slightly above the  $2\%$  discount rate.

While the discount rate changes couldn't be called outstanding announcements to the public since it was expected that credit would become tighter during the upswing, they were more aligned with the economic and monetary conditions of the time. Since with each upswing, the volume of stock purchased increases, the Fed raised margin requirements on loans for

CHART VIII

1958

55



- Three month Treasury bills (Monthly Average)
- Discount rate and adjustment period
- Prime rate
- Member bank borrowing (Monthly Average)

NOTE: All data is from various issues of the Federal Reserve Bulletin.

purchasing and/or carrying listed securities from 70% to 90% of market value.<sup>71</sup> One important outcome of the discount rate increases in 1958 was the rise of the prime rate from 3 1/2% to 4% during the August adjustment.

The Federal Reserve Board applied a restrictive monetary policy during 1959 to combat the prevailing upswing so that it wouldn't become inflationary. Subsequently, the discount rate was increased three times during the year, largely as a routine matter. The rationale behind all three discount rate increases was to keep the rates in appropriate relationship with the rise in market rates resulting from vigorous credit demands and to restrain undue credit expansion.<sup>72</sup>

The first change of the discount rate in 1959 was during March 6-16 to 3% from 2 1/2%. Three month Treasury bills had hovered around 2.8% since December, 1958, and were 2.76% on the week ending February 28, 1959. Federal Funds rates had increased by 1/2% since the beginning of the year to around 3%. Since the public already knew what the Fed's intentions were through open market actions, the discount rate increase in March was no new signal of intent. It was, perhaps, three months late. Prior to the increase, Fed open market operations sold \$1 billion of United States Government securities to maintain restraint on credit expansion.<sup>73</sup> As such, the

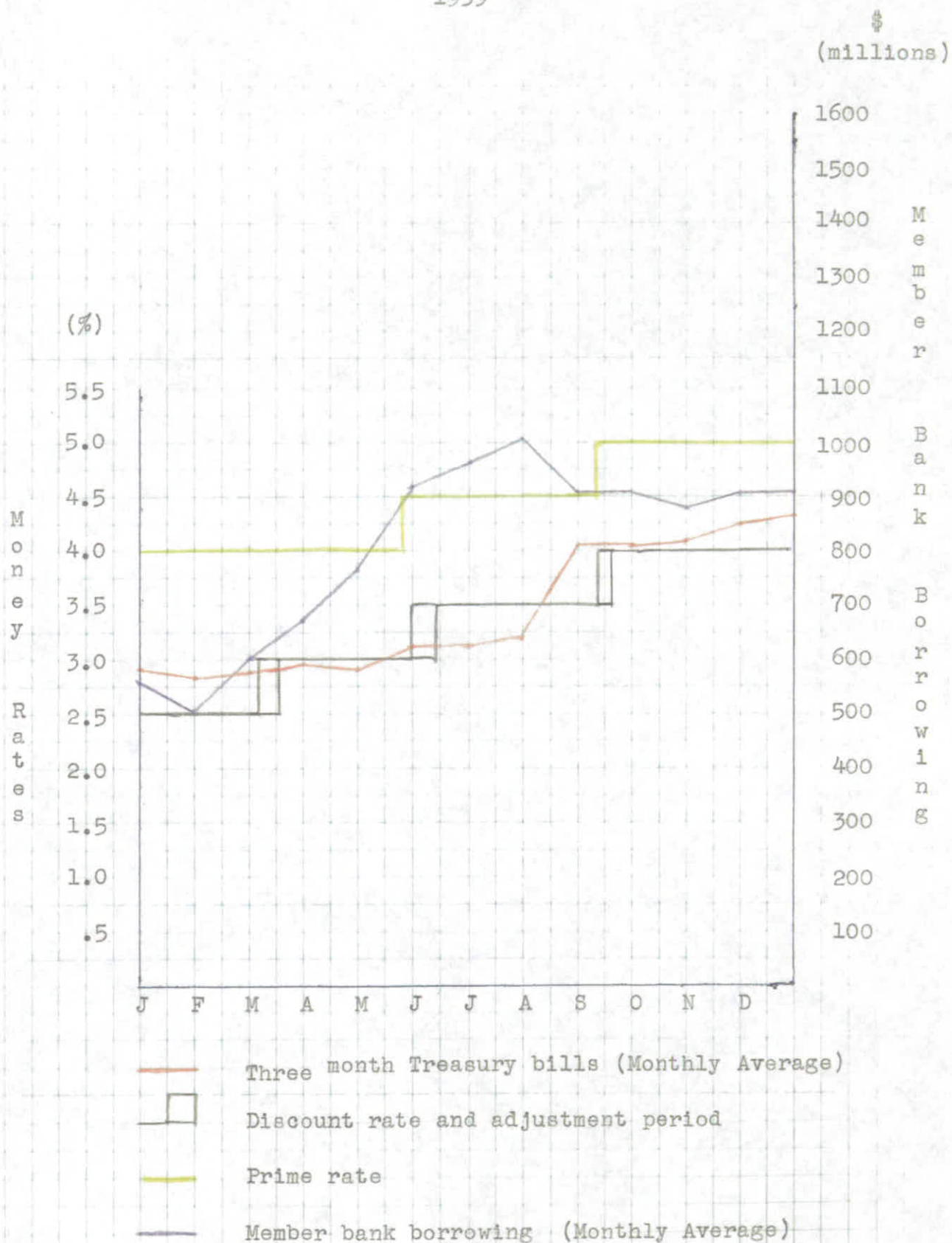
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<sup>71</sup>Ibid., p. 88.    <sup>72</sup>Ibid., p. 89.    <sup>73</sup>Ibid.

monetary system was controlled by open market operations until the discount rate changes came about.

Some factions of the money market were affected by the March discount rate change. Three month Treasury bills rose to 2.85% on the week ending March 14, but subsequently fell to 2.76% by the end of the month. Yields on Treasury notes and bonds followed a similar pattern.

The next two discount rate changes of the year were also routine in nature. The second discount rate increase was during the May 29-June 12 period by 1/2% to 3 1/2%. Three month Treasury bills averaged 2.95% in April and 2.85% on the week ending May 23. The Federal Funds rate had slightly surpassed the 3% discount rate before the change. The affect of this discount adjustment was felt in the prime rate which was increased from 4% to 4 1/2% in May in anticipation of the discount rate increase. The third discount rate increase was during September 11-18, in the plateau of the 1958-1961 cycle, to 4% from 3 1/2%. Three month Treasury bills averaged 3.38% in August and were 3.95% on the week ending September 5 and 4.02% on the week ending September 12. The Federal Funds rate was also varying around 4% at the time. Nothing outstanding can be said about these discount rate increases since they were well timed and considered as an accepted part of counter-cyclical monetary policy. Open market operations at this time bought and sold small amounts of United States



NOTE: All data is from various issues of the Federal Reserve Bulletin.

Government securities to supply special reserve needs for limited periods.<sup>74</sup>

The previous five discount rate increases were part of a more refined Fed discount policy. The increases, aggregating 2%, were mostly on time with economic conditions and public demands as well as with the Administration's desires. The performance of the Fed during this period established the discount rate more as an integral part of the counter-cyclical mechanisms the country has at its disposal.

In 1960, the Fed accurately predicted an economic downturn by increasing open market operations in late March. Nearly \$1.5 billion of Government securities were purchased.<sup>75</sup> However, the three month Treasury bill rate had dropped from its cyclical high of 4.49% in December, 1959, to 3.29% in May, 1960. Member bank borrowing had dropped from \$905 million in January to \$502 million in May. As such, the discount rate reduction from 4% to 3 1/2% during June 3-14 was rather late. However, the rate decrease was instigated to closer align it with market rates and to reduce the cost of member bank borrowing from the Reserve banks. The discount rate adjustment was a signal of Fed's attitude, in that inflation was no longer considered a problem, both production and employment were presumed to be stimulated by the lower rate, and that a change toward more flexible monetary policy was

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<sup>74</sup>Ibid.

<sup>75</sup>Ibid., p. 90.



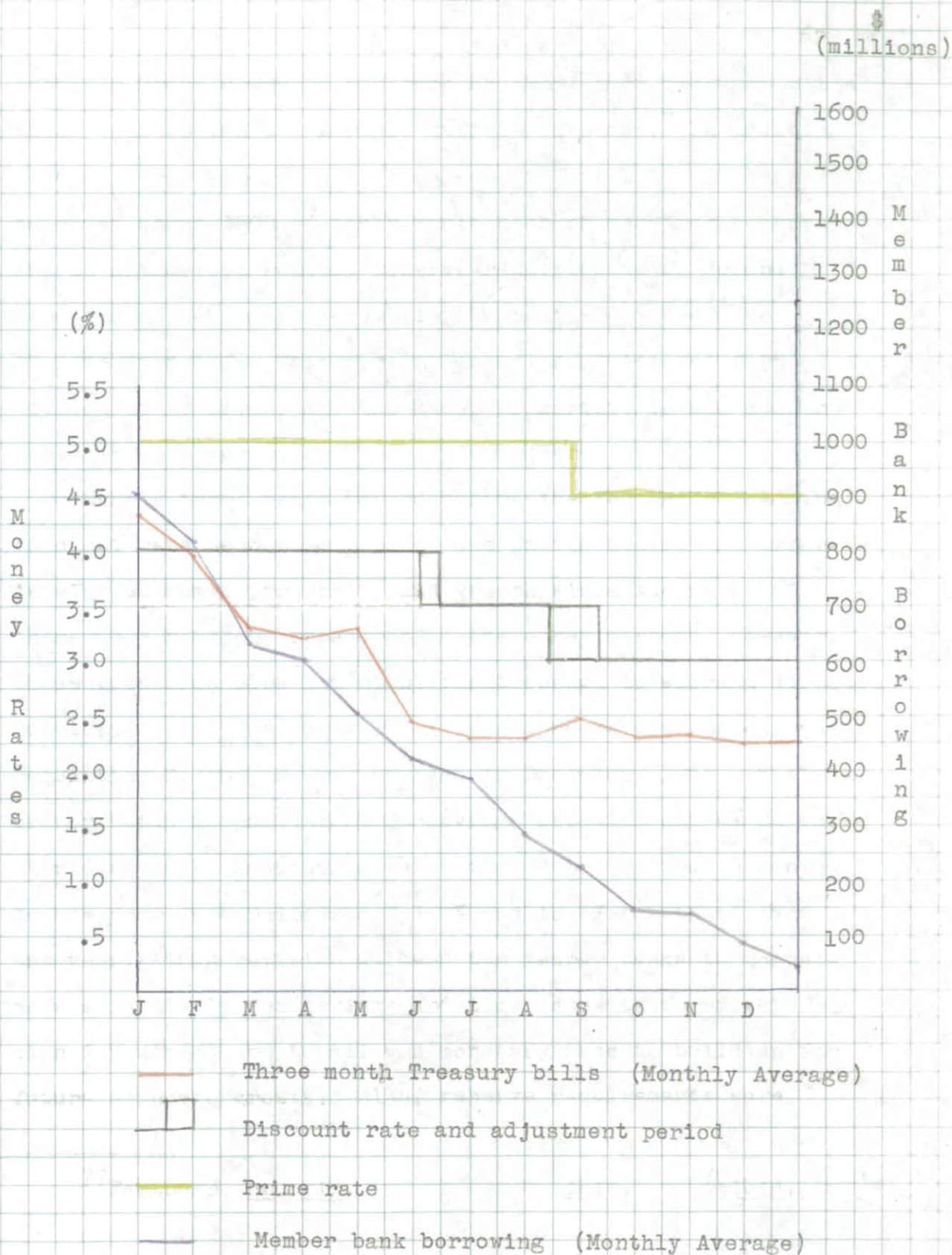
being conducted as was considered necessary by the public.<sup>76</sup> After the change, the stock market jumped sharply. The reason for this was that investors possibly considered the increase the little extra insurance needed for a good business year to come. Member banks, however, still holding onto a 5% prime rate, wanted to see their deposit--or reserve--increased before they endorsed a cut in lending rates.

The rationale for the other discount rate reduction in 1960 was the same as for the previous action. Three month Treasury bills averaged 2.30% in July and 2.13% on the week ending August 6. The Federal Funds rate was near 3% by August. Member bank borrowing decreased from \$502 million in May to \$388 million in July. As such, the discount rate was reduced by 1/2% to 3% during August 12-September 9. Perhaps the most significant reaction to come out of this action was the reduction of the prime rate during August 22-23 from 5% to 4 1/2%. This discount rate manipulation can be considered well timed and in line with the then prevailing monetary ease. To complement the discount rate action, Fed open market operations purchased about \$1 billion of Government securities. This action, taken during August through November, was to help member banks meet changing reserve needs and to help offset the impact of a large gold outflow without

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<sup>76</sup>"Fed Loosens Up Another Notch," Business Week, (June 11, 1960), p. 25.

1960



NOTE: All data is from various issues of the Federal Reserve Bulletin.

exerting undue downward pressure on short-term Treasury bills which could stimulate further outflow of funds.<sup>77</sup> In addition to open market operations, the Fed authorized member banks to count about \$500<sup>million</sup> of their vault cash as required reserves, and it authorized reduced reserve requirements on demand deposits at central reserve city banks to be reduced to 17 1/2% from 18%. This move released an additional \$125 million of reserves, and was made, primarily, to aid member banks in meeting seasonal needs for reserve funds.<sup>78</sup>

Nearly three years passed before the Fed again used the discount rate mechanism. Since the United States was experiencing economic prosperity and growth since August, 1960, there were numerous pressures on the money market. However, these pressures were not significant enough to warrant directed monetary control measures other than open market operations. Regulation Q, though, was revised in December, 1961, to allow member banks to pay 3 1/2% on savings deposits and 4% on those over one year. Maximum rates on time deposits from 6 months to one year were raised to 3 1/2% and to 4% for those over one year.<sup>79</sup> This revision allowed the member banks to compete more effectively for savings and time deposits to offset foreign investment and to allow a monetary base to build up for future economic growth. Also, reserve requirements were

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<sup>77</sup>Eastburn, op. cit., p. 91.

<sup>78</sup>Ibid.

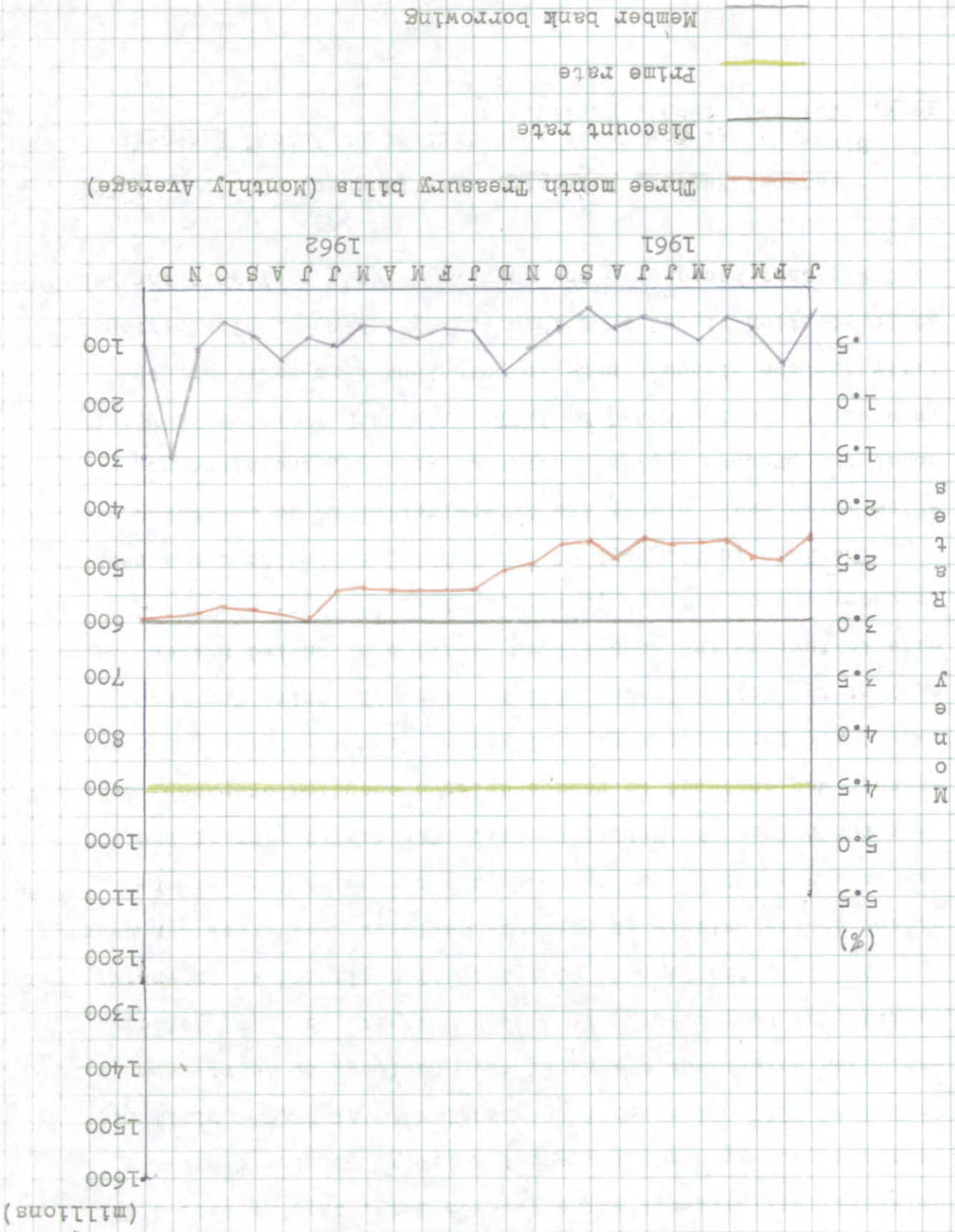
<sup>79</sup>Ibid., p.92.

adjusted on time deposits to 4% from 5%, releasing \$780 million in reserves. This move was made to minimize downward pressure on interest rates on short-terms and to allow a monetary base to build up for future economic growth. Other than these actions, then, the open market operations performed the role of monetary stabilizer, and, as such, monetary policy turned quite inflexible.

During the interim, the money market rates were considerably below the prevailing 3% discount rate. Three month Treasury bills averaged 2.36% monthly in 1961 and 2.77% in 1962, and 2.92% in the first half of 1963. Federal Funds rates varied from a high of 2.89% to a low of 1.35% during 1961 and 1962. Member bank borrowing from Reserve banks averaged \$79.5 million monthly in 1961, \$78.7 million in 1962, and \$153.3 million during the first half of 1963. Although the scene was set for a discount rate increase to bring it into closer alignment with short-term rates of interest and to stimulate member bank borrowing, this was not done. As a result, with the low yields received on short-term securities of American issue, an influx of foreign short-term investment was prevalent during the interim period.

The United States had witnessed, during the past five years, a persistent build-up of its short-term liabilities to foreigners, nearly \$17 billion. This balance of payments deficit occurred even after the payment of \$18 billion in gold in consequence of the perennial deficit in United States

NOTE: All data is from various issues of the Federal Reserve Bulletin.



1961-1962

CHART XI

international payments accounts. In 1963, that deficit still persisted and not reducing substantially. In the first six months of 1960, it reached an annual rate of \$3.5 billion, excluding government transactions.<sup>80</sup> Outflows of short-term capital had been contributing materially to the 1963 deficit.

As such, the Kennedy Administration planned an intensive attack on the balance of payments deficit. The first maneuver was to use monetary policy to reduce the outflow of short-term funds from the United States. The second part of the assault was designed to reduce defense spending overseas, to demand greater insistence on lowering European trade barriers against the United States, and to renew the drive for tax cuts to improve the competitive position of United States industry and to attract foreign capital.<sup>81</sup>

The Fed, in its part of the battle, wanted to use a mechanism which would signal its determination to do something about the present capital outflow. As such, the discount rate was to be increased by 1/2%. Although there was a possibility for the discount rate to push long-term rates up, the administration viewed that this wouldn't happen. The rationale used was that because of the supply of funds available through

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<sup>80</sup>Federal Reserve Bulletin, XLIX (August, 1963), p. 1063.

<sup>81</sup>"Stage Set for Boost in Fed Discount Rate," Business Week, (July 13, 1963), p. 112.

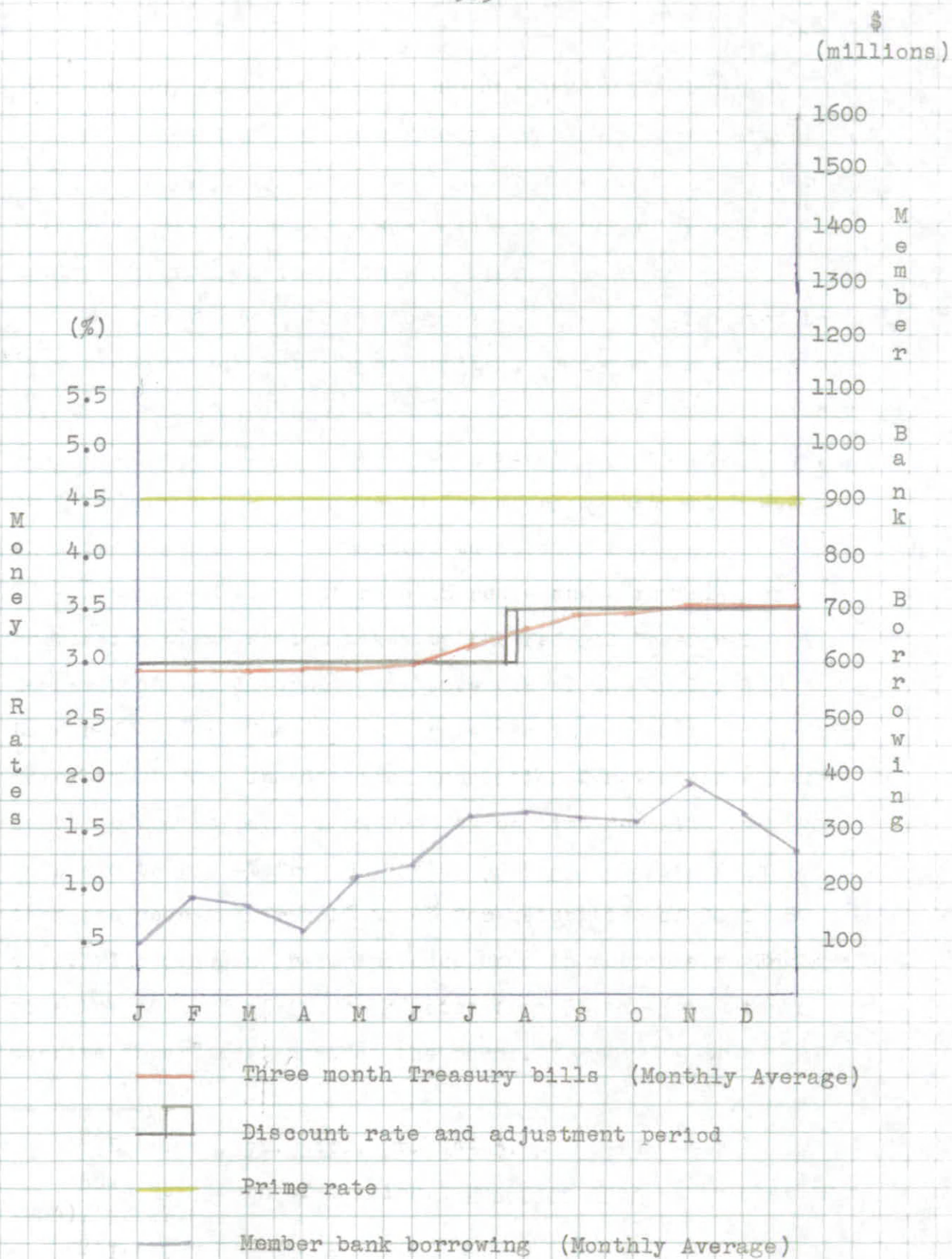
long-term investments couldn't be pushed up, or so it was believed, because of the strong economy, and the belief that the use of monetary policy for balance of payment reasons wouldn't slow the economy down.<sup>82</sup> The goal was also to increase the discount rate without increasing the prime rate, which had been at 4 1/2% since August, 1960, the last discount rate change.

The discount rate increase which followed was one of the few which wasn't directed solely and directly for alignment with market interest rates. The discount rate, then, rose from 3% to 3 1/2% during July 17-26. Three month Treasury bills were 3.22% on the week ending July 13, and they climbed steadily for the remainder of the year meeting the new discount rate by November. In conjunction with the discount rate move, the Federal Reserve Board revised Regulation Q by increasing to 4%, effective July 17, 1963, the maximum rate of interest member banks were permitted to pay on time deposits and certificates with maturities of 90 days to one year.<sup>83</sup> The combined monetary action, then, was to help reduce short-term capital outflows by firming United States short-term money market rates and to permit member banks to compete more effectively for funds, both foreign and domestic, available for investment.

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<sup>82</sup>Ibid., p. 113.

<sup>83</sup>Federal Reserve Bulletin, XLIX (July, 1963), p. 946.



NOTE: All data is from various issues of the Federal Reserve Bulletin.



This action, aimed at helping cease a potential drain on United States monetary reserves associated with persistent deficit in balance of payments, did not constitute a major change in Fed policy. It was a directed use of monetary control mechanisms for a specific purpose.

Congruent open market operations also were directed toward reducing the outflow of capital. Between the middle of May and December, Fed open market operations purchased nearly \$2.3 billion of United States Government securities.<sup>84</sup> This, in turn, produced tightness in the money market which was to minimize the outflow of capital to foreign nations.

A combined discount rate increase and a revision of Regulation Q was action taken by the Federal Reserve Board to maintain the international strength of the dollar in November, 1964. The discount rate was increased to 4% during November 24-30. In addition, Regulation Q revisions allowed member banks to pay 4 1/2% from 4% on time deposits over 90 days and to pay 4% from 3 1/2% on savings deposits held less than one year and from 1% to 4% for maturities of 30 to 89 days.<sup>85</sup> The discount rate increase came in response to England's rise November 23 of its bank rates from 5% to 7% to stop a massive "bear" raid against the pound.<sup>86</sup> According to

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<sup>84</sup>Eastburn, op. cit., pp. 94-95.

<sup>85</sup>"A New Touch of Caution," Business Week, (November 28, 1964), p. 27.

<sup>86</sup>Ibid.

Chairman Martin of the Board of Governors, the Fed action was an "insurance policy" against any outflows of funds from the United States which might result from Britain's move.<sup>87</sup> The rationale behind the dual actions was to counter possible capital outflows that might have been prompted by any widening spread between United States interest rates and foreign interest rates and to ensure the flow of savings to member banks for domestic investment finance.<sup>88</sup>

Open market operations were also used for this purpose. In late November to December, the Fed purchased about \$750 million of Government securities to ensure that the rise in money market rates following discount rate actions would not restrict the availability of domestic credit.<sup>89</sup>

The November discount rate action produced generally critical reactions.<sup>90</sup> Some financial and economic circles believed that the British dilemma was just an excuse for the Fed to do what it was planning on anyway. Although the majority of the governors of the Federal Reserve had urged for stronger policy, Chairman Martin insisted that the move was taken only for international reasons. Some experts predicted an increase in the prime rate. This never happened.

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<sup>87</sup>Ibid.

<sup>88</sup>Federal Reserve Bulletin, L (December, 1964), p. 1520.

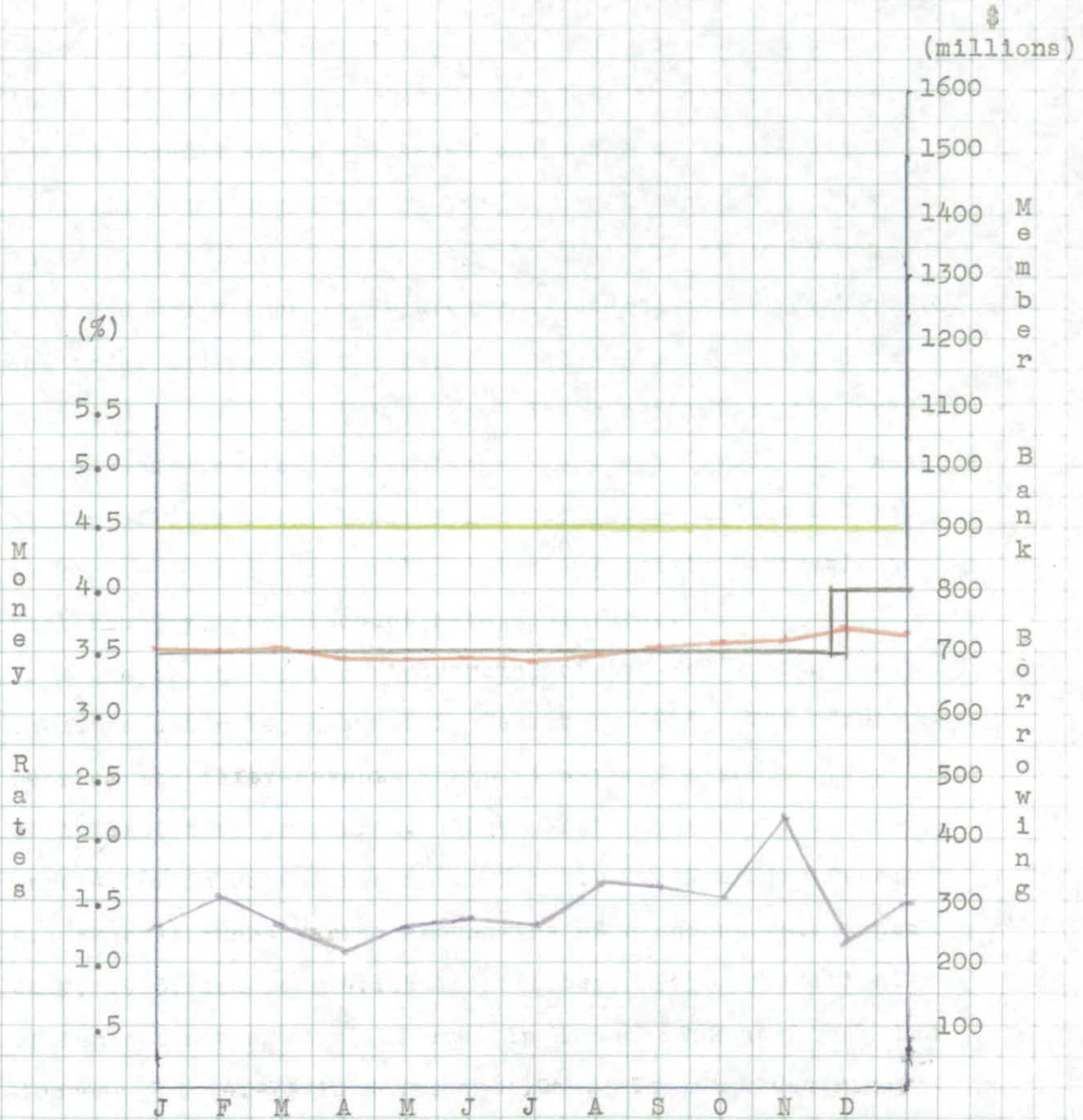
<sup>89</sup>Eastburn, op. cit., p. 96.





<sup>90</sup>"A New Touch of Caution," op. cit., pp. 27-28.

CHART XIII

1964

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-  Three month Treasury bills (Monthly Average)
-  Discount rate and adjustment period
-  Prime rate
-  Member bank borrowing (Monthly Average)

NOTE: All data is from various issues of the Federal Reserve Bulletin.

John Kenneth Galbraith charged that the Fed had yielded to those who wanted higher interest rates; to please them and not to benefit those who never had money to lend. Other economists saw a slackening of United States growth rate during the middle of 1965 and felt that the discount rate increase would lead to generally tighter money. However, the Fed tried to promote the idea that the discount rate didn't necessarily mean tighter money. It characterized the prevailing monetary policy as "cautious, less easy", but one "essentially of ease", the implication being that if the British bank rate increase turned the sterling crisis favorable to that country, the discount rate would drop.<sup>91</sup>

One of the most controversial of the Fed's adjustment of the discount rate occurred in December, 1965. The economy was nearing its fifty-seventh month of expansion and showing signs of inflationary pressures. Three month Treasury bill yields were 4.08% in November and 4.12% on the week ending December 4. Federal Funds varied around the 4% discount rate since July, 1963, and were 4.10% in November, 1965. Certificates of Deposit rates, first offered in May of 1962 at 2.94%, had increased to 4.47% in November, 1965. The time was right for an increase in the discount rate. Prior to the discount rate increase in December, the Johnson Administration and

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<sup>91</sup>Ibid.

and economic and financial sectors desired it to prevent "a deterioration in the quality of credit", brought about by intense bank competition for high volume at extraordinarily small profit margins.<sup>92</sup>

Considering the inflationary pressures on the economy, Chairman Martin pressed for a discount rate increase on the theory that the most effective time to combat inflation is during the development stage. As such, the discount rate was increased during December 6-13 to 4 1/2% from 4%, highest in 35 years. The increase was intended to "moderate additional bank reliance on short-term borrowings from the Federal Reserve to meet intensifying loan demands."<sup>93</sup> The action provided additional reserves to member banks to meet seasonal pressures as well as the then expanding credit needs without promoting excesses, primarily through the purchase of Government securities on the open market.<sup>94</sup> During the December-January transition period, open market operations aided the reserve positions of member banks through open market purchases aimed at softening the shock of the discount rate move.

In connection with the discount rate increase, the Fed revised regulation Q on December 6. The revision permitted

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<sup>92</sup>Michael E. Levy, "Increase in the Discount Rate: Timing, Motivation, Economic Effects," Conference Board Record, III (January, 1966), p. 14.

<sup>93</sup>Ibid.

<sup>94</sup>"Discount Hike Starts to Pinch Bank Loans," Business Week, (February 5, 1966), p. 26.

member banks to pay 5 1/2% on time deposits over 30 days, 4% on 30 to 89 day time deposits and Certificates of Deposits, and 4 1/2% on 90 days and over on time deposits and Certificates of Deposits. The intention of the revision was to attract and retain deposits and to make effective use of savings funds already available in the economy to finance their loan expansion.<sup>95</sup>

The combined action of the discount rate increase and the Regulation Q revision was hoped to have a three-pronged impact. First, it was to help prevent inflationary excesses in developing in an economy carrying the added expense of the Viet Nam war. Secondly, it was to aid the Government's program to overcome a persistent deficit in the United States balance of payments, running at an annual rate of \$1.85 billion during the first three quarters of 1965. Thirdly, it was to again demonstrate the determination to maintain the international strength of the dollar.<sup>96</sup>

The Federal Reserve Board's action on the discount rate was heavily criticized. The move was considered an "open declaration of independence by the Federal Reserve Board against the Administration"<sup>97</sup> since the discount rate was

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<sup>95</sup>"Federal Reserve Policy Actions," Federal Reserve Bulletin, LI (December, 1965), p. 1667.

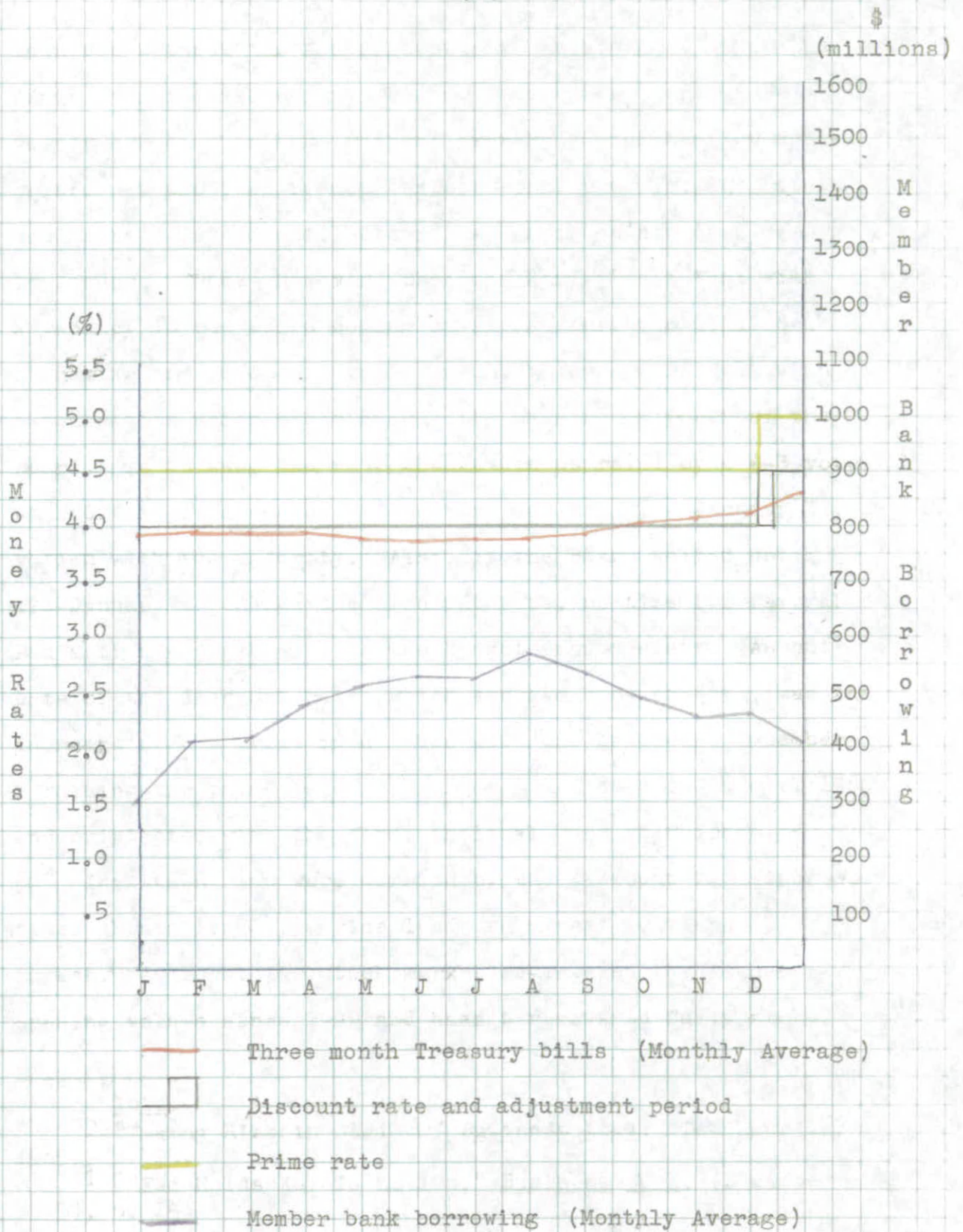
<sup>96</sup>Ibid., pp. 1668-1676.

<sup>97</sup>Levy, op. cit., p. 14.

CHART XIV

1965

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NOTE: All data is from various issues of the Federal Reserve Bulletin.

adjusted without the Administration's knowledge. Since the Administration was against higher interest rates, the Fed wasn't expected to move without express Administration authority. It was felt by many experts that the discount rate wouldn't be raised until after the President's budget message in January, 1966. However, Chairman Martin felt that with a vacancy in the Board coming up in January, the likelihood of making any future restraint would be more difficult with a nomination which would change the balance of power of the Board. As it was, the rate change was approved by a 4-3 vote, with Governor Baderston, whose term was expiring January 31, voting with the majority.<sup>98</sup> Also, if the Board waited until mid-January to change the discount rate, no time for favorable Fed action would be due to the budget announcement. An outcome of the discount rate, which enraged some experts, was the increase of the prime rate. The move was conducted December 6 raising the prime rate to 5% from 4 1/2% set in August, 1960, and originated with the First National Bank of Chicago.<sup>99</sup>

Investment men were worried by the discount rate increase since, historically, a rise leads to a peak in the stock market.<sup>100</sup> As such, the stock market registered the highest opening volume since 1929 and hasn't recovered fully since.

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<sup>98</sup> Ibid.

<sup>99</sup> "Taking Rise in Stride," Business Week, (December 11, 1965), p. 25.

<sup>100</sup> "Fed Holds Key To Action," Business Week, (December 11, 1965), p. 141.



## CHAPTER V

### CONCLUSION

The importance of the discount rate as a counter-cyclical weapon has varied since the passage of the Federal Reserve Act. The rise of the open market operation as a monetary tool for stabilizing a prevailing policy has minimized the use of discount rates. Although the discount window was used somewhat during the 1920's, it was little used from 1934 through 1952. During most of the 1930's, member banks never readily used the discount window due to the large excesses of reserves. Thus, the mechanism had a standby significance. During World War II, and until early 1951, member banks found it more advantageous to dispose of United States Government securities for replenishment of reserves rather than to utilize the discount window. These securities, of which member banks had large amounts due to Federal Reserve financial commitment of the war, were supported by the Fed. After the Treasury-Federal Reserve Accord of 1951, the support policy was discontinued leaving the securities in the hands of supply and demand forces.

It was not until after the Accord that the discount rate assumed real importance. Since the Accord removed Fed support of Government securities, yields were free to rise. Thus, when yields rose above the discount rate, the discount window

became an attractive source of reserve funds because of the lower cost to the member bank. The time was right for the use of the discount rate as an integral part of counter-cyclical monetary policy, but no need arose for it. When the Fed did turn to discount policy, it caused a reluctance for member banks to borrow with discount rate increases which goes along with an ingrained attitude against going into debt. As such, the member banks sold open-market assets and tightened loan policy to avoid borrowing from the Reserve banks, as in 1954. When the Fed forced member banks to borrow in 1953 and 1955, the only effect it had was to cause uncertainty as to the use of the mechanism and as to the effect on the business community.

After the Federal Reserve Board revised Regulation A of the Federal Reserve Act in 1955, the importance of the discount rate as a counter-cyclical mechanism was re-established. Although the revision more-or-less just restated the original Regulation, the implication was that the Fed condoned and promoted the use of the discount window by member banks to meet reserve stringencies, its prime purpose. It reasserted that the use of the discount window was a privilege, not a right, of Federal Reserve System membership.

The Federal Reserve Board's rationale behind discount rate changes has been varied. The majority of the discount rate changes were: (1) to align the discount rate closer to

short-term market rates of interest, three month Treasury bills in particular, and (2) to eliminate the discount rate as a deterrent to member bank borrowing by lowering it or to make borrowing more expensive by raising it. Discount rate changes tend to lag behind these market rates. Market rates could be undergoing a transition period and would, thus, be expected to fall, as they did in late 1959 and early 1960. Here market rates were above the 4% discount rate for four months. The Fed allowed the rates to ride themselves out since the economy was at a cyclical plateau. The discount rate actually becomes the anchor around which other rates generally float. This is an important consideration when the Fed changes it.

The first use of the discount rate as a signal of monetary policy was during 1956. The signal aspect of the discount rate is the major significance of it. As such, with the raising of the discount rate, the Fed signals to the public, business community, and financial and economic interests the credit policy which will be either tightening or will soon be tightened. And, with the lowering of the discount rate, greater ease is likely to be the policy. Therefore, since member banks had resorted to borrowing on a scale large enough to allow the discount rate to be influential as a counter-cyclical tool, the Fed used the 1956 discount rate increases to signal a tightening monetary and credit policy.

Although the Fed has adjusted the discount rate to be consistent with the economic and monetary conditions of the time, there have been instances of untimeliness. In 1957, three month Treasury bills as well as other other short-term rates were averaging above the prevailing 3.0% discount rate for eight months. Just after the discount rate adjustment, the economy had a down-turn which could be partially to blame on the Fed since it hadn't acted when it should have, thus causing superfluous ideas about the economy. However, the discount rate adjustments during 1958, 1959, and 1960 could be considered timely and routine, aligning it with short-term market rates and signalling a restrictive or easy monetary and credit policy.

The discount rate changes in the 1960's expansion were directed toward international considerations. Here, rate adjustments were keeping the rate in line with short-term market rates so as to aid in retaining capital in the United States by tightening the short-term market. As such, it was used to better the balance of payments position and to uphold the international strength of the dollar.

The real role of the discount rate is to signal a change in credit policy so that open market operations and reserve requirement adjustments can affect the reserve position of member banks, more heavily. As such, the actual change in the credit conditions is due to the open market operations.

With each discount rate change, open market operations are conducted to supplement the move. When the discount rate is increased to tighten the money market, open market operations sell Government securities, thus sopping up excess reserves. Open market operations purchase securities when the discount rate is reduced to aid in the easing monetary policy.

At times, reserve requirements are adjusted as a supplementary action to discount rate changes. In 1963, in order to more effectively combat a balance of payments deficit resulting from the movement of short-term capital from this country, reserve requirements were lowered in conjunction with a discount rate increase. The move further supported the discount rate's purpose and allowed member banks to compete more effectively for domestic and foreign funds.

The Federal Reserve Board's use of the discount rate, then, is primarily that of a signal of intentions in regard to the monetary and credit policy the Board has at its disposal. The discount rate's role is largely psychological, using open-market operations as a back-up. The rationale behind a Federal Reserve discount rate change is dependent upon general and specific economic and financial conditions, but is mainly used as an anchor rate around which short-term market interest rates usually float.

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