STRICTLY CONFIDENTIAL

STRICTLY CONFIDENTIAL (FR) August 29, 1966.

TO: Board of Governors

FROM: Robert C. Holland

SUBJECT: Development of revised program for discount administration.

Pursuant to the direction of the Board, discount officers from the Federal Reserve Banks of New York, Philadelphia, and Chicago met today with members of the Board's staff in an endeavor to develop a practical program for adapting discount administration insofar as feasible to the restraint of business lending. Attached are the results of that meeting, in the form of two drafts:

(1) "Revised Program for Discount Administration in the Current Economic Environment", and

(2) "Letter to Member Banks Concerning Need to Restrain Business Lending".

While the discount officers had at their disposal the Board staff memorandum of August 19, 1966, "Draft Memorandum on Coordination of Discount Administration with Other Instruments of Monetary Policy", and a summary of the oral comments and selected written comments of that memorandum by the Federal Reserve Bank Presidents, they found it most practicable to develop fresh language for the attached documents. The program encompassed in these documents, they believe, represents as far as the System can feasibly go in adapting discount administration to the objectives which the Board has expressed, so long as the existing institutional framework is to be maintained. The kinds of contacts with member banks proposed in this program they regard as no more than an extension of the kinds of representations concerning total loan curtailment that have already been made by some discount officers to their member banks.

The discount officers caution that the effectiveness of the program suggested below will be hard to measure, and will probably be no more than modest at best. Furthermore, they feel this program may not remain viable if business needs for bank credit to finance defense production should accelerate.

While all the caveats expressed by the discount officers may be well taken, I think the program herein presented represents an effort in the direction of rebalancing credit pressures that might usefully be undertaken.

If the Board finds this program to be worthy of consideration, copies of it might be forwarded to each Reserve Bank President with a request for his further comment. President Wayne, in his capacity as Chairman of the Conference of Presidents, has written the Board requesting that time be allowed "for a careful review of the proposed policy by System discount officers and for further discussions with members of the Conference." At the moment, the next convenient opportunity for a meeting of the Board and the Presidents would be in conjunction with the Federal Open Market Committee meeting on September 13; and the first practical opportunity for a round-table discussion by System discount officers would be at their scheduled conference, September 19-20. Potential market developments in the interim, however, may very well make it inadvisable to delay until these dates System discussion and final adoption of the program in question.

Attachments 2

DRAFT

FOR INTERNAL SYSTEM USE ONLY

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REVISED PROGRAM FOR DISCOUNT ADMINISTRATION IN THE CURRENT ECONOMIC ENVIRONMENT

In the current business and financial situation, it is contemplated that it will prove necessary and desirable within the next few weeks and months to impel member banks to borrow substantially greater amounts than at present from their respective Reserve Banks. This would be accomplished by maintaining current Regulation Q ceilings while conducting sufficiently restrictive open market operations so as to give rise to a substantial run-off in CD's or declines in other types of deposits, and perhaps also occasional drying up of sources of inter-bank borrowing.

This operational strategy is deemed necessary in order to slow down the rate of bank credit expansion. From an economic stabilization point of view, however, this strategy can only be effective if the lending policies of the Reserve Banks tend to curtail bank lending to those segments of the economy where the greatest recent expansion has taken place. At the same time, it is necessary that pressures on the banking system do not result in a demoralization of other financial markets, e.g., the municipal market, as the banks endeavor to adjust their positions.

It is believed that Federal Reserve Bank discount administration can help to accomplish the desired objectives <u>within the framework of the present Regulation A</u>. It is likely that in those situations where there is a sharp run-off of CD's or a drying up of inter-bank sources of funds, it may be necessary, as the Regulation in fact has anticipated,[1/] to lend to banks for somewhat longer than usual periods of time. Such longer periods of credit extension would permit the borrowing bank to make some adjustment in the area of business loans rather than concentrating their adjustment in the earning asset categories of investments, real estate mortgages, and other loans.

While discount officers should refrain from making decisions for member banks, they should nevertheless urge the desirability of undertaking adjustments in business loans. In any case, it should be made clear--again in accordance with the present Regulation[2/]-- that expansion of business loans at current rates is not in the public interest and will not be condoned while the member bank is in a position of having to borrow from the Federal Reserve Bank.

Indicated needs for industrial credit during the next few months are such that it is altogether likely that member banks will have to forego loans to some well-established prime customers. It is not intended that System policy prevent member banks from meeting legitimate and normal seasonal needs, especially where they have made some preparation to take care of this themselves; it is intended,

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1/ ". . . Federal Reserve credit is also 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 difficulties or from exceptional circumstances involving only particular member banks. . . ." Regulation A, Section 201.0, par. (d).

2/ Regulation A, Section 201.0, par. (e), quoted on page 3.

however, that the seasonally adjusted rate of expansion of business loans shall be reduced.

The emphasis on slowing down the rate of growth of a particular category of loan is a departure from recent discounting tradition and practice. It is felt to be necessary because of the Board's conclusion that the present rate of expansion of business loans is supporting an unsustainable rate of growth of business investment, with unsound consequences for economic and financial conditions. The Foreword to Regulation A has anticipated this possibility. It specifies that "each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally." It is this concern for "sound credit conditions," rooted in the Federal Reserve Act itself, which makes it currently necessary to bring to bear those aspects of discount administration which are designed to deal with unusual circumstances.

While the standards of discount accommodation outlined above can only affect directly those banks that are indebted to the Federal Reserve Banks, the Federal Reserve Banks are encouraged to continue to take the initiative in communicating with any other banks whose general liquidity position and lending activity are such that they might soon need to borrow from the Federal Reserve. The System's policy and the reasons for it should be explained to them in an effort to encourage them to anticipate their needs and to make adjustments in their lending policies that would be appropriate to the situation.

In addition, the examination function will be asked to pay particular attention to the liquidity position of all member banks. Where appropriate, examination officials might be invited to participate jointly with discount officials in contacts with member banks whose liquidity position and lending activity are out of keeping with the program herein enunciated.

The accompanying statement from the Board of Governors addressed to all member banks supplies a public expression of the Federal Reserve's point of view on these matters that may be usefully referred to in discussions with member banks.

STRICTLY CONFIDENTIAL (FR) August 29, 1966.

D R A F T

FOR PUBLIC RELEASE

LETTER TO MEMBER BANKS
CONCERNING NEED TO
RESTRAIN BUSINESS LENDING

It is the view of the Federal Reserve System that currently strong demands for credit need to be restrained in order to hold credit-financed spending within the bounds that can be accommodated by the Nation's physical resources. Business demands for bank credit are particularly intense, and while such credit requests often seem justifiable when looked at individually, the aggregate total of business spending so financed is reaching unsustainable levels and adding substantially to inflationary pressures. Furthermore, such loan expansion is being financed by liquidation of other banking assets in ways that can be prejudicial to other financial markets.

The System believes that it serves the national economic interest to reduce the rate of expansion of bank loans to business, within the context of a program of overall monetary restraint. Accordingly, this objective will be kept in mind by the Federal Reserve Banks in granting credit to those member banks that are led to borrow at the discount window by reason of shrinkages in deposits or other sources of funds. Borrowing banks will be expected to cooperate in reducing the rate of business loan growth as part of the orderly adjustment of their positions. This is in conformity with

Section 201.0, par. (e) of the Board's Regulation A governing lending to member banks:

> "In considering a request for credit accommodation, each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally. ..."

Federal Reserve credit assistance to member banks to meet temporary, emergency, or normal seasonal demands from their customers will continue to be available in accordance with the standards set forth in Regulation A.

The curtailment of the recent extraordinary rate of business loan expansion is in the interest of the entire banking system. The Board expects all banks to be aware of this consideration, whether or not they need to borrow. Management of bank resources in accordance with the principles outlined above can make a constructive contribution to sustainable economic prosperity.