

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

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

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

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

THE NEW LOOK IN DISCOUNT POLICY

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

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

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

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

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