

banks with branches abroad began bidding unusually high rates for Eurodollars, and bidding for Federal funds became similarly aggressive. At times Federal funds were traded at 6 per cent or more, although the discount rate was only $4\frac{1}{2}$ per cent at the time.

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

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

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

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

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

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