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

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

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

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

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

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

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

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

I. Competition Between Large Member Banks and Small Member Banks

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

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