

The Fed restricts or eases monetary policy by destroying or creating bank reserves. Reserves are created by either lending reserves through the discount window or purchasing securities on the open market. Similarly, reserves are destroyed by terminating advances or by selling securities on the open market. If it is desirable that a certain level of reserves are to be maintained, because of the requirements of monetary policy, any creation of reserves by one mechanism must be offset by destruction of reserves through the alternative mechanism.

In recent years, the Fed has relied on open market operations to implement monetary policy. There has been little opportunity for two of the Federal Reserve policy instruments to move in opposite directions because of the reliance on a single instrument. With the discount window opened and its use encouraged during periods of monetary tightening, a leak apparently will be created in the control mechanism.

What happens with greater lending through the discount window? Every dollar lent through the window will increase the lending capacity of the commercial banking system. A new dollar of reserves is also being created. Each of these additional dollars of new reserves must be offset through open market operations by selling Government securities held by the Fed. The sale of securities by the Fed drives down their price and hence drives their interest rate up. Driving up interest rates on short-term money market obligations encourages the transfer of funds from thrift institutions to the security markets and reduces the ability of mortgage financing institutions to compete for funds. Thus, the Fed in helping commercial banks adapt to changing monetary conditions can well magnify the difficulties of the nonbank financial intermediaries.

It can be argued that the Fed's more liberal use of the discount window will have a destabilizing effect on mortgage lending flows in periods of monetary ease as well as monetary tightness. When the Fed is easing monetary policy, the banks will probably reduce their advances to the Federal Reserve. A rapid repayment of advances must be offset by System purchases. The additional System purchases would tend to drive short-term rates down still further and thus cause a sharp increase of funds flowing to mortgage lending institutions. The possibility of this development does not seem remote when the Fed's report states:

"The existence of the discount mechanism, however, provides a means for individual banks to cushion temporarily the impact of such policy moves and therefore enables the trading desk of the Federal Reserve Bank of New York to carry out the System's open market operations more aggressively than would otherwise be practicable."⁵

By increasing the feast or famine response of intermediaries to monetary change, the more liberalized use of the window may aggravate the cyclical nature of housing activity—further retarding when it is already suffering from the effect of tight money and stimulating it when it may already be producing at near capacity.

The potential sums involved in under use of the discount window may be substantial. The Fed did not provide dollar figures in their report or in the statement of George Mitchell to the Joint Economic Committee. A conservative estimate based on the capital stock and surplus of member banks indicates a basic borrowing privilege

⁵ Report of a System Committee, p. 4.