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NEW CREDIT PROGRAM AT THE DISCOUNT WINDOW

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CASE DESCRIPTION

The primary subject matter of this case concerns the effect of the new credit program at the discount window on the behavior of the federal funds rate. The objective is to teach students how the basic demand-and-supply framework is employed to analyze the conduct of monetary policy in the reserve market. This case would be appropriate for a money and banking class, a monetary economics class, a financial economics class, an intermediate or an advance macroeconomic theory class. Level of difficulty could be at three or four. The case is designed to be discussed in one and one-half hours and should take students less than three hours of outside preparation.

CASE SYNOPSIS

The Federal Reserve employs three monetary policy tools: the required reserves, the open market operation (which affects the federal funds rate) and the discount policy. Traditionally (i.e., before January 9, 2003), the Fed set the discount rate below the targeted market federal funds rate, but prohibited banks from using the discount window. As a result, the volume of outstanding discount loans was normally small even though the discount rate is cheaper than the federal funds rate.

On January 9, 2003, the Federal Reserve introduced new lending programs, which are different from their predecessors in several aspects. The most significant changes are (1) the discount rates are now set above the prevailing federal funds rate, and (2) banks face very few restrictions on their use of primary credit. The proposal to make such changes is based on the following beliefs. First, it will eliminate the existing incentive for banks to borrow from the window to exploit the positive spread, and hence reduce the administration necessary for each discount loan. Second, as a result, it should help encourage banks to turn to the discount window only when the reserve markets tighten significantly and thereby the window serves as the last resort and a backup source of liquidity for individual depository institutions. Third, the discount rate will become an improved safety valve for releasing significant market pressures.

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INTRODUCTION

Will Thomas is a researcher at a large bank. He has been closely following the decision making process that the Federal Reserve Bank has been going through in the last several months on what to do about its discount lending program. Now it is official. As of January 9, 2003 the Fed will change its discount lending procedures. Will knows that his bosses will now be expecting a complete analysis from him on how these changes will impact 1) discount lending and the economy and 2) their bank and banking practices.

THE REPORT

So far Will has gathered the following information and written it up for the introduction of his report. It is as follows:

> On January 9, 2003 the Federal Reserve System will enact amendments to Regulation A so that the discount rate will be set above the targeted federal funds rate instead of below it. This amendment will also replace the adjustment credit and extended credit lending programs with primary credit and secondary credit lending programs.
>
> The primary credit program will allow pre-approved depository institutions to get very short-term loans from the discount window at a rate which will initially be set at 100 basis points above the targeted federal funds rate. This program is quite similar to the adjustment credit program with two major exceptions. 1) Depository institutions will pay an interest rate above the fed funds rate for this loan, and 2) they will not need approval for the loan at the time of going to the window. Any pre-approved depository institution will automatically be eligible for the funds. The Fed sees this as a cost-saving move. As an added bonus, the Fed feels that by setting the discount rate above the targeted federal funds rate, the federal funds rate will be "capped", thereby keeping the target and actual rates closer together. The Fed also gains a way to release upward pressure on the fed funds rate when reserves markets become tight.
>
> The secondary credit program will allow depository institutions that do not meet the pre-approval standards to have access to short-term loans. Extended credit will also be granted through this program. The interest rate for this program will be set at 50 basis points above the discount rate for the primary credit program. This program will operate in very

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much the same way as the extended credit program did with the addition of short-term loans for non pre-approved depository institutions.

The Fed has opted not to make any changes to its seasonal lending program at this time.

BACKGROUND INFORMATION FOR YOUR ASSIGNMENT

In the past, Will's bank, like many others, never used the discount window to obtain short-term credit to deal with overnight shortfalls of reserves even though the discount rate was lower than the federal funds rate. It was just never an option that was allowable due to the large amounts of paper work involved and the bad market signal that might be sent. Only once did the bank's president want to borrow from the discount window to take advantage of the large spread between the discount rate and the federal funds rate and it had been Will who had convinced him not to.

Will's bank has an excellent CAMELS rating so he feels certain that the bank would meet the requirements for primary credit. Thus he has decided to focus his energy on fully explaining the primary credit lending program as that is the program that should most directly affect his bank. Will realizes that his report will have to give very specific justifications about why the "top brass" at his bank even need to take the time to read his report on the changes that are taking place. Will feels that by answering the following questions he will have a solid report that shows all the advantages of the new program for his bank and convinces the president and board that the primary lending program is something they need to be aware of.

Will has enlisted your help in researching and answering his list of questions. You should use supply and demand in the reserve market to help with the analysis of each question (Hint: graphs are helpful).

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