Should the Discount Rate be a Penalty Rate?

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The Federal Reserve Board announced in October 1979 that greater emphasis would be placed on reserves in monetary policy implementation. Since that time, however, the growth rates of both reserves and money have continued to display considerable short-run variability. As a result, some observers have concluded that the Federal Reserve needs to exercise closer short-run control over reserves in order to achieve its monetary objectives. In particular, it has been suggested that the Federal Reserve should maintain the discount rate above market rates to reduce the size and variability of discount window borrowing. Because depository institutions would be required to pay a premium for funds obtained through the discount window, keeping the discount rate above market rates is often referred to as a penalty discount rate mechanism.

Advocates of a penalty rate argue that the current method of administering the discount rate impairs the effectiveness of the reserve approach to monetary control and maintain that reduction in the variability of borrowing would eliminate a major “leakage” in the monetary control mechanism. These analysts contend that a penalty discount rate would facilitate monetary control because it would enable the Federal Reserve to better control the supply of reserves. Thus, advocates of a penalty rate believe that it is a necessary component of a reserve approach to monetary control.¹

Opponents of a penalty rate argue that a substantial reduction in the variability of discount window borrowing would be inadvisable. They maintain that variability in discount window borrowing furnishes a safety valve that provides depository institutions with the necessary flexibility to adjust to variations in the demand for and supply of reserves.

Moreover, opponents of a penalty rate deny that less variability in discount window borrowing would necessarily improve the Federal Reserve’s control of reserves and money. Indeed, they maintain that a penalty discount rate may prove to be inconsistent with the reserve approach to monetary control.

The purpose of this article is to evaluate the impact of a penalty discount rate on monetary policy implementation. The article first discusses the effects of a penalty rate on the Federal Reserve’s ability to control the supply of reserves. Next, the question of whether it is consistent with a reserve approach to monetary control is analyzed. Then, the article discusses the impact of a penalty rate on monetary control, under the assumption that it is consistent with reserve targeting. Finally, the article examines the impact of a penalty rate on the volatility of interest rates.

A PENALTY DISCOUNT RATE AND THE SUPPLY OF RESERVES

This section discusses the impact of a penalty rate on the Federal Reserve’s ability to control the supply of reserves. The supply of reserves—that is, the volume of reserves available to the nation’s depository institutions—may arise from three different sources. One source is reserves supplied through borrowing from the Federal Reserve. Commercial banks that are members of the System have for many years had access to credit from their Federal Reserve Banks. Under the Monetary Control Act of 1980, this access was extended in mid-1980 to nonmember commercial banks and other depository institutions. While a number of circumstances may give rise to discount window borrowing, most of the credit extended by the Federal Reserve is used to facilitate short-run adjustments that depository institutions make in meeting their legally established reserve requirements.

Under the nonpenalty rate approach currently employed, the interest rate charged on discount window credit is typically maintained somewhat below rates on alternative sources of funds, such as the Federal funds rate. For this reason, banks typically have an interest rate incentive to borrow from the Federal Reserve, although borrowing is held down by a “reluctance to borrow” philosophy on the part of banks and by the System’s administrative procedures governing access to the discount window. Nevertheless, in borrowing from the Federal Reserve, depository institutions are influenced by market interest rates and their relation to the discount rate. Thus, during periods of rising interest rates, when the spread between market rates and the discount rate tends to widen, borrowing from the Federal Reserve tends to increase. Similarly, borrowing tends to decline during periods of falling market interest rates. Under a penalty discount rate, in contrast, in which the discount rate would be maintained above market interest rates, the volume of borrowing would not respond to changes in interest rates.

A second source of reserves is Federal Reserve open market operations—that is, the buying and selling of U.S. government securities by the Federal Reserve. For example, funds from an open market purchase are deposited in a commercial bank and thereby increase the supply of reserves.

A third source of reserves is technical market factors—that is, various assets and liabilities of the Federal Reserve that are not controllable by the System. For example, an unexpected outflow from Treasury deposits at the Federal Reserve would provide reserves to the banking system. Reserves provided through open market operations and technical factors are referred to as nonborrowed reserves—that is, reserves supplied through sources other than borrowing at the discount window. The total supply of reserves may be written as:
$$\text{TRS} = \text{NBR}_0 + \text{NBR}_T + \text{BR}$$

where \(\text{TRS}\) = total supply of reserves,
\(\text{NBR}_0\) = reserves supplied through open market operations,
\(\text{NBR}_T\) = reserves supplied by technical factors, and
\(\text{BR}\) = reserves supplied through the discount window.

The Federal Reserve affects the supply of reserves by controlling open market operations, \(\text{NBR}_0\), and by affecting borrowing by establishing the discount rate. The System's ability to precisely control the supply of reserves, \(\text{TRS}\), depends on its ability to predict and offset variations in technical factors, \(\text{NBR}_T\), and borrowing, \(\text{BR}\).

To the extent that unexpected changes occur in technical factors, a penalty discount rate would not increase the Federal Reserve's ability to control the supply of reserves. Under a nonpenalty rate, unexpected changes in technical factors tend to be partly offset by changes in borrowing, reducing the undesirable impact on reserves of such variations in technical factors. Under a penalty rate, though, borrowings do not change in response to changes in technical factors.

For example, suppose the Federal Reserve, wanting total reserves to remain unchanged and expecting no change in technical factors or borrowings, maintains \(\text{NBR}_0\) unchanged. Now suppose \(\text{NBR}_T\) declines unexpectedly. The drop in reserves provided by technical factors would tend to reduce total reserves, which would place upward pressure on interest rates. Under a nonpenalty discount rate, the rise in interest rates would lead to an increase in borrowing, thereby offsetting some of the decline in technical factors. Under a penalty discount rate, total reserves would decline by the amount of the drop in technical factors because borrowing would not increase in response to the rise in interest rates. Under a penalty rate, compared to a nonpenalty rate, then, total reserves would deviate from desired behavior by a larger amount.

Nevertheless, despite the tendency for a penalty rate to prevent changes in borrowing from countering unexpected changes in technical factors, a penalty rate would probably improve the Federal Reserve's ability to control the supply of reserves. This is because a penalty rate would prevent changes in borrowing from offsetting the impact on reserves of open market operations, that is, of changes in \(\text{NBR}_0\). Under a nonpenalty rate, these changes in borrowing impair the Federal Reserve's ability to control total reserves. For example, suppose the Federal Reserve wants to bring about a decline in reserves and expects \(\text{NBR}_T\) to remain unchanged. In this case, the System reduces \(\text{NBR}_0\), which reduces reserves and tends to cause interest rates to rise. Under a nonpenalty rate, the rise in interest rates leads to an increase in borrowing, which offsets part or all of the impact on reserves of the decline in \(\text{NBR}_0\). A penalty rate would prevent the rise in borrowing so that reserves would drop by the amount of the decline in \(\text{NBR}_0\). This tendency for borrowing, under a nonpenalty rate, to offset the effects of open market operations is probably more significant than the tendency for borrowing to offset changes in technical factors. Thus, a penalty rate probably would improve the Federal Reserve's ability to control the supply of reserves.

**A PENALTY DISCOUNT RATE AND RESERVE TARGETING**

While a penalty rate probably would improve control over the supply of reserves, it may not be consistent with the reserve targeting approach to monetary control. Under this approach, the Federal Reserve estimates the level of nonborrowed reserves that is thought to
be consistent with the System’s desired monetary growth rate. Then, the Federal Reserve uses open market operations to achieve the predetermined level of nonborrowed reserves.

The extent that a penalty rate is consistent with reserve targeting depends in part on the reserve accounting system that is in operation. Under the existing lagged reserve accounting system (LRA), the amount of reserves that depository institutions are required to hold during any week depends on the level of deposits they had outstanding two weeks earlier. Under a contemporaneous reserve accounting system (CRA)—which has been advocated by some in the belief that it would improve monetary control by providing a closer linkage between reserves and money—the level of required reserves for any week depends on the level of deposits outstanding during that week.

To analyze the relationship between the reserve accounting system and a penalty discount rate, it is useful first to discuss briefly the interaction of demand and supply in the market for reserves. In that market, the demand for reserves interacts with the supply of reserves to determine the level of interest rates on short-term money market instruments. In other words, changes in short-term interest rates bring about, in the market for reserves, a balance between the demand for and the supply of reserves. When demand exceeds supply, interest rates increase, which tends to cause the demand for reserves to decline and/or the supply to increase. The rise in interest rates continues until demand no longer exceeds supply. Similarly, when supply exceeds demand, interest rates tend to decline until supply and demand are in balance.

Under the LRA system currently in operation, a penalty discount rate is not consistent with reserve targeting. Since required reserves during any week are fixed at a level related to deposits two weeks earlier, the demand for reserves in that week is not sensitive to changes in interest rates. Thus, changes in interest rates do not lead to changes in the demand for reserves. Consequently, any imbalance between the demand for and the supply of reserves must be eliminated by changes in the supply of reserves—either in nonborrowed reserves or in borrowed reserves. Under current operating procedures, the changes occur in borrowed reserves because the Federal Reserve supplies a predetermined level of nonborrowed reserves. For example, when the demand for reserves exceeds the supply, the resulting rise in interest rates encourages banks to increase their borrowing, thereby expanding the supply of reserves.

A penalty discount rate, however, would eliminate the responsiveness of borrowing to changes in interest rates. Consequently, the supply of reserves would not be responsive to interest rates. Under these circumstances, there would be no mechanism for assuring an equilibrium in the market for reserves. For example, when the demand for reserves exceeds the supply, the resulting increases in interest rates would not lead to greater borrowing and to an increase in the supply of reserves. The imbalance in the market for reserves would lead to an indeterminate increase in interest rates. At

2 Adjustments in excess reserves could, in principle, result in interest sensitivity of the demand for reserves under LRA. However, excess reserves in recent years have remained near frictional levels and have displayed little or no systematic response to changes in interest rates. Therefore, it is unlikely that adjustments in excess reserves would provide an adequate mechanism for ensuring balance between reserves supply and demand. Moreover, it is possible under LRA that required reserves would exceed nonborrowed reserves. In this case, there is in principle no adequate method for reserve adjustment even if excess reserves are responsive to interest rates. Therefore, this article focuses on adjustments in required reserves as the only practical method of ensuring balance between reserve supply and demand when the Federal Reserve closely controls the supply of reserves.
some point, the Federal Reserve would be forced to end the rise in interest rates by expanding the supply of nonborrowed reserves. Since the current procedures are based on maintaining a predetermined level of nonborrowed reserves, a penalty rate is inconsistent with the procedures under the current system of lagged reserve accounting. Therefore, a penalty discount rate clearly would not be desirable unless the reserve accounting system were changed to CRA.

Under CRA, a penalty discount rate is more likely to be consistent with the reserve aggregate approach to monetary control. Required reserves during any week, under CRA, are related to deposits in that week. Therefore, if the public’s demand for deposits—and thus depository institutions’ demand for reserves—is sensitive within a week to interest rates, any imbalance between demand and supply could potentially be eliminated by changes in the demand for reserves induced by interest rate movements. For example, when the demand for reserves exceeds the supply, the resulting rise in interest rates would encourage the public to reduce their holdings of deposits, which would in turn reduce the demand for reserves. Thus, even though a penalty discount rate would eliminate the responsiveness of the supply of reserves to changes in interest rates, contemporaneous reserve accounting may possibly provide a mechanism for assuring an equilibrium in the market for reserves. Under CRA, then, a penalty discount rate may possibly be consistent with reserve aggregate targeting.

Whether a penalty discount rate would in practice be consistent with reserve targeting depends mainly on the short-run sensitivity of the public’s demand for money to changes in interest rates. If the demand for money is very responsive to interest rates, then a penalty rate would be consistent with reserve aggregate targeting. However, if money demand does not respond within a week to interest rate changes, a penalty discount rate probably would not be consistent with reserve targeting, even if the accounting system were changed to CRA.

A PENALTY DISCOUNT RATE AND MONETARY CONTROL

This section analyzes the impact of a penalty discount rate on monetary control assuming that a penalty rate is consistent with reserve targeting. For these purposes, it is assumed that the Federal Reserve adopts CRA and that the demand for money responds within a week to changes in interest rates. Under these assumptions, the section analyzes whether a penalty rate would result in better control over the actual stock of money balances held by the public and thereby allow the Federal Reserve to better achieve its money stock targets. To analyze the impact of a penalty rate on

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3 Presumably, the Federal Reserve would begin expanding the supply of nonborrowed reserves when the Federal funds rate increases above the upper limit of the range established by the FOMC. At this point, the Federal Reserve would, in effect, be forced to follow an interest rate rather than a reserve aggregate approach. Of course, this may occur without a penalty rate, but it would occur more often with a penalty rate. This is because, with a penalty rate and a fixed supply of nonborrowed reserves, the absence of any equilibrating mechanism would result in a very volatile Federal funds rate. The rate would tend to either increase or decrease sharply. In practice, the Federal Reserve would be forced to abandon a nonborrowed reserves target in order to keep the funds rate within its range.

4 The interest elasticities of depository institutions’ demand for excess reserves and of the public’s demand for nonmonetary deposits would also influence the extent to which a penalty discount rate would be possible under CRA. Unfortunately, there is little evidence regarding the very short-run interest responsiveness of the public’s demand for monetary and nonmonetary deposits and of depository institutions’ demand for excess reserves. The available evidence suggests that the demand for reserves is unlikely to be very responsive to interest rates within a period of time as short as a week. See Helen T. Farr, Steven M. Roberts, and Thomas D. Thompson, “A Weekly Money Market Model,” Special Studies Paper No. 86 from the Board of Governors of the Federal Reserve System.
monetary control, it is helpful to identify the factors that determine the stock of money and to show how the Federal Reserve acts to maintain the money stock in line with targeted levels.

The stock of money is determined by the demand for money—that is, the amount of money the public wants to hold—and by the supply of money—the amount of money balances depository institutions are willing to provide. The amount of money demanded by the public depends primarily on the levels of interest rates and income. For example, an increase in income or a decline in interest rates leads to an increase in the demand for money. The amount of money depository institutions are willing to provide depends on the amount of reserves available to support monetary deposits. Thus, the supply of money depends positively on the total supply of reserves, TRS, and negatively on the amount of reserves used for purposes other than to support monetary deposits. These purposes include both excess reserves, ER, and required reserves against nonmonetary liabilities, RRN. The total reserve supply consists of nonborrowed reserves, NBR, plus discount window borrowing, BR. The money supply relationship may be written as:

\[ M^S = f[NBR + BR - RR_N - ER]. \]

In equilibrium, the amount of money the public wants to hold must be equal to the amount of money furnished by depository institutions. Changes in interest rates are the primary mechanism for ensuring balance in the short run between the demand for money and the supply of money.

The Federal Reserve affects the stock of money by affecting the supply of reserves. It does so by controlling nonborrowed reserves and establishing the discount rate. Under current procedures, the Federal Reserve estimates the level of nonborrowed reserves that will result in an actual stock of money that equals the targeted level, then sets out to maintain the estimated level of nonborrowed reserves. In estimating the appropriate level of nonborrowed reserves, the System estimates the impact on the money stock of factors other than nonborrowed reserves—including the strength of money demand as well as the prospective behavior of discount window borrowing, excess reserves, and reserves used to support nonmonetary liabilities. If these estimates are accurate, the monetary authorities will be successful in achieving the money stock targets. However, unexpected changes in the demand for money or in ER and RRN will lead to a divergence between the actual and targeted money stock.\(^5\)

Whether or not a penalty discount rate potentially would improve monetary control depends on the relative significance, in terms of frequency and magnitude, of unpredicted shifts in the demand for money compared to changes in the supply of money caused by ER and RRN. A penalty rate would not improve monetary control if unpredicted changes in ER and RRN factors are more important than are unpredicted changes in money demand.

As indicated, such changes in ER and RRN cause the stock of money to deviate from the level targeted by the Federal Reserve. Under a nonpenalty discount rate, however, changes in ER and RRN give rise to changes in borrowing. The changes in borrowing partly offset the impact on the money supply of the changes in these two factors, reducing the extent that the money stock deviates from targeted levels. Under a penalty discount rate, however, changes in borrowing would not occur in

\[^5\] It is assumed, for simplicity, that the Federal Reserve can precisely predict the relationship between discount window borrowing and the spread between market interest rates and the discount rate. If this were not so, variability in the “borrowing function” could also impair the Federal Reserve’s ability to achieve its monetary objectives.
response to changes in ER and RR\textsubscript{N}. Under a penalty rate compared to a nonpenalty rate, then, the money stock would deviate from targeted levels by a greater amount in response to unexpected changes in excess reserves and reserves used to support nonmonetary liabilities.

For example, suppose there is an unexpected increase in the demand for excess reserves. This would lead to a decline in the supply of money, which would be accompanied by an increase in interest rates. Under a nonpenalty discount rate, part of the impact on the supply of money of the increase in the demand for excess reserves would be offset by a rise in borrowed reserves because banks tend to borrow more as interest rates increase. However, under a penalty rate, borrowing would not increase, and none of the impact on the supply of money of the rise in excess reserves would be offset.

A penalty discount rate would improve monetary control if unpredicted shifts in the demand for money were more important than changes in money supply factors (ER and RR\textsubscript{N}) in causing the money stock to diverge from targeted levels. Unpredicted changes in the demand for money are likely to cause larger deviations under a nonpenalty rate than under a penalty rate. This is because a change in the demand for money under a nonpenalty rate leads to a change in borrowing and therefore in the supply of reserves and money. Under a penalty rate, though, a change in monetary demand does not bring about a change in borrowing.

For example, suppose there is an unexpected increase in the demand for money. The rise in the demand for money would lead to an increase in interest rates. Under a nonpenalty discount rate, the increase in interest rates would encourage depository institutions to increase their borrowing. The greater supply of borrowed reserves would lead to a rise in the stock of money. However, under a penalty discount rate, borrowing would not increase in response to the increase in interest rates. Thus, there would be no rise in the supply of reserves or in the stock of money.

**A Penalty Discount Rate and Interest Rate Volatility**

The analysis in the preceding sections has shown that a penalty discount rate would improve monetary control under a reserve aggregate approach if certain conditions are met. First, the System would be required to institute CRA to ensure that there is some mechanism for balancing the supply of and the demand for reserves. Second, technical market factors affecting reserves need to be predictable enough that the Federal Reserve is able to control nonborrowed reserves through open market operations. Third, unexpected shifts in the demand for money are required to be more pronounced in their impact on the money stock than are unanticipated changes in factors affecting the supply of money.\(^6\) A final condition is that the demand for money would have to respond within a week to changes in interest rates.

Even if these conditions were met, however, a penalty discount rate may not be desirable. This is because a penalty rate would increase the short-run volatility of interest rates. When the supply of money does not respond to changes in interest rates, as it would not under a penalty rate, changes in the demand for money lead to relatively larger changes in interest rates. Moreover, the smaller the interest rate sensitivity of demand, the greater the volatility of interest rates. Thus, even if demand is somewhat sensitive to interest rate changes, the

\(^6\) It is important to note that if factors affecting the money supply are more important than money demand shifts, the reserves approach to monetary control may not be appropriate. See J. L. Pierce and T. D. Thompson, "Some Issues in Controlling the Stock of Money," in *Controlling Monetary Aggregates II: The Implementation*, Federal Reserve Bank of Boston, September 1972, pp. 115-37.
introduction of a penalty rate may sharply increase the short-run volatility of interest rates. The adverse impact of this volatility on the economy may outweigh the improvement in monetary control that a penalty discount rate would produce.\textsuperscript{7}

While a penalty rate may result in unacceptable interest rate volatility, it might be possible to change the system for administering the discount rate to improve the Federal Reserve's control over reserves and money. In particular, the beneficial monetary control results from reduced variability in discount window borrowing would require more rapid and timely adjustments in the discount rate than have taken place under current arrangements. A system possibly could be designed that would allow the discount rate to change with market interest rates within a specified range or with a set time lag. For example, the discount rate could be determined by a formula based on the average level of the Federal funds rate over a specified number of previous weeks. This formula could be altered from time to time, or temporarily suspended as events warranted. Alternatively, a surcharge on discount window borrowing, similar to the one that is now in effect, could be made permanent and maintained at a penalty level. Either of these alternatives would be consistent with reserve targeting whether or not contemporaneous reserve accounting is adopted. Moreover, either alternative would probably improve the Federal Reserve's ability to control the stock of money while resulting in less volatility in interest rates than would a pure penalty discount rate.

**CONCLUSIONS**

The argument that a penalty discount rate is needed to achieve adequate monetary control under a reserve aggregate approach to policy implementation has been analyzed in this article. The analysis suggests that a penalty rate would probably improve the Federal Reserve's ability to control the supply of reserves because it would reduce the variability of reserves supplied through the discount window. However, improved control of the supply of reserves would not improve monetary control so long as the existing lagged reserve accounting system is retained. Indeed, a penalty rate is fundamentally inconsistent with reserve targeting under lagged reserve accounting. If a contemporaneous reserve accounting system were adopted, the improved control over the supply of reserves resulting from a penalty rate might increase the potential degree of short-run monetary control exercised by the Federal Reserve. However, a change to contemporaneous reserve accounting and a penalty discount rate would substantially increase interest rate volatility and might result in unacceptable disruptions in both the financial and real sectors of the economy. Therefore, a penalty discount rate might be inadvisable even if the Federal Reserve adopts contemporaneous reserve accounting.

\textsuperscript{7} It should be noted again that the discussion in this section assumes that contemporaneous reserve accounting is in effect. The reserve accounting system also has implications for interest rate variability. In some cases, a shift to CRA without the adoption of a penalty discount rate would result in an increase in interest rate volatility. For a discussion of the costs of interest rate volatility, see R. Lombra and F. Struble, "Monetary Aggregate Targets and the Volatility of Interest Rates: A Taxonomic Discussion," *Journal of Money, Credit, and Banking*, Vol. 11, No. 3, August 1979, pp. 284-300. An empirical analysis of the implications of the reserve accounting system for monetary control can be found in J. A. Cacy, Bryon Higgins, and Gordon H. Sellon, Jr., "Control Over Reserves and Money Under Contemporaneous and Lagged Reserve Accounting," Research Working Paper 80-05, Federal Reserve Bank of Kansas City, August 1980.