

desirable quantity of reserve credit cannot on all occasions be achieved merely by assuring the eligible character of the paper rediscounted. On occasions of rapid business expansion, in which inflationary conditions develop, the supply of eligible paper always increases. This increase may be due in part merely to general increases in commodity prices. Although the reserve banks were given power, on such occasions, to discourage the increase in member bank rediscounting, by raising their rates and consequently the cost of reserve credit, experience has further shown that the effectiveness of rate increases is subject to many limitations. Some of these limitations arise from the considerable differences in money rates which prevail over various parts of the country so that discount rates which would effectively restrain some member banks from excessive rediscounting might not thus operate to restrict the activities of other member banks.

Manner of
Utilization
of Credit

With these limitations upon rediscount policy to secure for the country the desirable aggregate of bank credit, it would appear that rediscount devices are principally important from the standpoint of their ability to encourage the desirable type of credit activities of member banks. But restrictions upon eligibility determine only the way reserve credit may come into being and do not insure its subsequent utilization by member banks in encouraging either commercial or short-time agricultural operations.

Consideration
of Member
Banks' Condition

Member banks, whose assets are generally becoming frozen and uncollectable, may discount their best paper with the reserve banks and in this way build up the reserves which permit them to increase their extensions of long-time and perhaps unsound credits to the business community. If the reserve banks rest content merely in securing sound paper, they may protect themselves adequately, but at the cost of threatening the safety of the other creditors of the member banks, including the depositors. In the event of failure, these depositors may find that their bank has pledged its best assets with the reserve bank and that their ability to recover has been in large part destroyed. It should be clear that in the general welfare the reserve banks cannot act in disregard of the interests of the bank's depositors even though their own security has been maintained.

Right to
Refuse Discount

The right of a federal reserve bank to refuse to rediscount eligible paper has been upheld in the federal courts. In one important decision it is stated: "Certainly it was lawful to engage in open market transactions by the sale of securities, to fix the rediscount rate and to decline to rediscount eligible paper . . . It is important to note that it (the federal reserve bank) is not under any compulsion to rediscount eligible paper, for the words of the Act in respect to rediscounting are wholly permissive."

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