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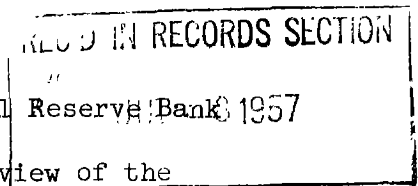
To Members of the Federal Open Market
Committee

March 5, 1956



The attached memorandum prepared by the Federal Reserve Bank of New York may be of interest in connection with the review of the authorization to purchase bankers' acceptances.

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Results of System Bankers' Acceptance Operations to Date

As almost a year has passed since the System re-entered the bankers' acceptance market, it would seem desirable to evaluate the results thus far. The Annual Report submitted to the Federal Open Market Committee summarized the operations themselves, and the main developments in the acceptance market over the nine months during which we maintained a portfolio in 1955. There have been no important changes of substance in that record since the year end. The next step should be to ask whether any real progress has been made toward fulfilling the broad aims and objectives that the Federal Open Market Committee had in view when the System re-entered the acceptance market.

I. OBJECTIVES

Stated broadly, the objective of the Federal Open Market Committee in authorizing acceptance operations, was that the System should assist in the further development of an acceptance market in the United States, with a view to improving this country's means of financing foreign trade and the functioning of an international money market. As a gesture indicating to observers here and abroad that the System was taking a direct interest in the "classic" mechanism of international short-term credit, and as encouragement to those engaged in such financing here, the step could be helpful in readying facilities that might be very useful when sterling and other currencies become more fully convertible. Whether real progress has been made toward the ultimate goal is difficult to judge at this point. Any improvement in the means of financing foreign trade so far has been negligible, as expected, but certain modest changes have taken place which may be counted as steps in the right direction and may, in the long run, contribute toward the broad ends that the Committee originally had in view.

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II. EFFECTS ON ORGANIZATION AND FUNCTIONING OF THE DEALER MARKET

As to the direct effects of our operations on the market itself, there have been some gains of a tangible nature. The most important of these has been in the use of repurchase agreements to help the dealers finance their acceptance portfolios. Although this facility was extended only when repurchase agreements were also being made against Government securities and at the same rates, the lift to the dealers was substantial in some periods and encouraged them to take a more positive role in their market at times of money market strain. In addition to supplying reserves, this would seem to be a good supplementary reason for continuing to make repurchase agreements in such circumstances.

It had also been hoped that as a corollary of the System's operations, the acceptance market might develop a more flexible attitude toward rates. The dealers' previous reluctance to move their rates except under severe pressures, such as a change in the discount rate or in the prime loan rate, had interfered with the market's response to the normal influences of demand and supply. This inflexibility may have played some part in keeping the volume and scope of acceptance activity on such a relatively small scale over the past two decades. While it was understood, of course, that we would take no direct action to influence dealer rates, and did not, the mere fact of our closer identification with the market may help to account for the considerably greater flexibility in rates that has been apparent in the past year. Perhaps this may be attributed in part to discussions held with the various dealers when the program started. At least one dealer, Mr. M. Greacen Briggs of Briggs, Schaedle and Company, was outspoken in suggesting that the acceptance market would benefit from more rate flexibility, as that should help keep the market fluid under conditions of imbalance in either

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demand or supply. He took the initiative on several occasions in changing rates, with the other dealers following suit, when it appeared there was something to be gained in terms of improving the demand and supply situation.

This rate variation was at times modestly effective in increasing or decreasing supply, operating to swing certain marginal borrowers in this country between bank loans and acceptance financing as comparative costs varied with changes in acceptance rates; large cotton and wheat firms were the principal borrowers to take advantage of these opportunities. Rate changes, however, had a less immediate effect on demand which, coming largely from foreign sources, was less volatile and tended to vary, if at all, with broader changes in Treasury bill rates. The full effectiveness of rate changes was not really tested because of continuing dealer reluctance to extend their rate changes for fear of incurring the displeasure of the local banks which were inclined to view any changes as a threat to the prime loan rate. With continued experience in this area dealers may achieve an even greater degree of rate flexibility.

It may be argued, of course, that freely fluctuating rates cannot be expected in the acceptance market because of the nature of those borrowing through this medium. Although some users of acceptance credit can take advantage of short-term rate swings, for example, the larger cotton and wheat merchants mentioned above, many users are not sufficiently close to the financial picture to be able to schedule their financing to obtain the best rates, and might merely be discouraged by the added difficulty of figuring their financing costs if rate changes were too frequent. This would apply especially to foreign users.

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III. EFFECTS UPON THE SUPPLY OF ACCEPTANCES

One of the continuing problems in the acceptance market has been the tendency of the larger banks to preempt for their own customers a large portion of the supply created by other large banks in exchange for their own acceptances. These transactions are, in effect, swaps through the dealers which reduce the amount of "free" acceptances available for purchase by others. By adding to market rigidities, these swap arrangements reduce general investor interest in the market since a large portion of the total volume is traded in this way. We can see no real break in this practice as yet, either as a result of our own interest in maintaining a portfolio or of the more flexible rate pattern.

As noted above, the greater degree of flexibility in dealer acceptance rates had some effect upon the supply of acceptances coming into the market. However, this was only an indirect result of our interest in the market and affected mainly the marginal borrowers who were in a position to shift readily from bank loans to acceptance credits.

The proposed sales of surplus commodities to foreign buyers by the Commodity Credit Corporation on liberal credit terms may add something to the supply of acceptances. However, as the best prospects of sale appear to be to buyers who need more than six months' credit, the chances of a substantial addition to the acceptance supply from this source will probably be limited. The fact that this alternative is being seriously considered, however, for any part of the financing that may be suited to the origination of acceptance credit, may be attributable in some measure to the renewed interest in the acceptance market that was produced by the System's entry into the market.

The supply of eligible dollar exchange acceptances has been curtailed over the past year or so by the fact that dollar exchange bills drawn by the

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Banco do Brasil have been considered ineligible for purchase by the Federal Reserve Bank in view of the conditions under which those bills were created. The fact that the Brazilian dollar position has been greatly improved over the past few months, and all of the ineligible acceptance credits retired, opens the way for Banco do Brasil to use this medium again on a more orthodox basis which could also add to the supply of acceptances coming to market.

IV. EFFECTS ON DEMAND FOR ACCEPTANCES

It does seem clear that the fact of System participation in the acceptance market has, in some degree, heightened interest in the market among the banks and the financial community generally. We have noted several new domestic buyers of acceptances for investment purposes in past months, including some large corporations, but we would not wish to claim that the publicity attending the System's renewed interest in acceptances was a determining influence in bringing them into the market. More likely this participation was brought out by the differential between acceptance rates and Treasury bill rates at the time. To some extent, our influence may have been somewhat in the opposite direction. That is, the availability of "free" acceptances has considerable bearing on the interest shown in them, and our operations have certainly "bitten into" the net supply available in the market at times. The continuing interest of foreign investors in acceptances has not been stepped up noticeably as a consequence of the System's action but, on the other hand, that interest has not been affected adversely as yet by the possibility of a change in tax rulings which would remove the present tax advantage to certain foreign holders.

V. EFFECTS ON FUNCTIONING OF FEDERAL RESERVE BANK OF NEW YORK

Through our operations it was expected that we would see a larger cross-section of the acceptances going through the market, from which we might be able

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to form better judgments as to trends and developments in the creation of acceptances. So far, we have not found enough of significance in our purchases to claim any substantial benefits along these lines. Statistically, the added sample which passes through our hands is too small to enable us to form valid conclusions. We shall, nonetheless, continue to study our purchases from the statistical standpoint with a view to using such material when we can. From a different angle, however, our examination of the added acceptances we purchase gives us a better opportunity of checking on the general soundness of acceptance credit, i.e., whether bank practice is in accord with standard acceptance practice and with regulations.

In the course of our market activities, dealers occasionally pressed to obtain help from us in ways which were at odds with current credit policy or with operating realities. In one instance, the dealers seemed to feel that we should buy more acceptances to aid the market by relieving dealer portfolios at a time when policy did not call for putting money into the market. In another case, it was intimated that our purchases should be larger to be in line with sizable purchases we were making of Treasury bills. In this latter situation, it was not practical for us to step up purchases because of the physical limitation on the amount of acceptances we can handle at any one time; we have not geared our operations to meet occasional peaks of this kind. Also we had, of course, to conform to the limit on total holdings authorized by the Federal Open Market Committee. This type of pressure from the market was to be expected and, aside from some temporary annoyance on both sides, we have been able to take it in stride.

One other problem is worth mention here. During several periods over the past year the supply of "free" acceptances in the market has been insufficient to cover our Foreign Department orders in addition to our own portfolio needs,

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sometimes by a considerable amount. This situation is likely to occur with some frequency when general demand tends to outrun supply, as it has over the greater part of recent years. Where policy has suggested maintaining our own portfolio at or around a particular level, we have divided our purchases as equitably as possible between our foreign accounts and our own portfolio, leaving the foreign accounts partly uninvested for periods of a few days. The only other solution, and a partial one at that, would be to let our own holdings run off faster than has been our practice when we are not actually trying to put money into the market. In other words, if the demand substantially outruns the supply to the extent that we cannot promptly meet our needs, we might buy only for our foreign accounts unless there is a positive need to put money into the market. The consequent decrease in our holdings could be replaced later as, and if, opportunities offered. In this way we would be managing our portfolio with less risk of interference with normal market demand and supply. At the same time, we would not be abandoning the market or compromising our obligations to our foreign correspondents. Purchases for our own account at such times tend to aggravate the demand-supply situation, and probably operate on balance to discourage foreign buying interest, since our Foreign Department tries to persuade our foreign correspondents to buy Treasury bills when acceptances are in short supply. As a generalization, the account management has felt that we should hold a minimum of $10 million if it were our objective to encourage and broaden the domestic market.

A further extension of technique would be to sell acceptances from our portfolio to the foreign accounts when consistent with our credit policy objectives. This could help to iron out the peaks and valleys in the market at appropriate times by removing, or at least reducing, one source of demand. The approval of the Federal Open Market Committee would be required to make

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such sales, as our present authorization contemplates the possibility of sales only to dealers, and not to our foreign accounts. In the case of Government securities, of course, direct transactions between the System Account and various foreign accounts have frequently occurred, whenever that would be of direct assistance in implementing the current policy objective.

Either approach might at times, however, make it more difficult to maintain our portfolio at any preconceived level, or to have it fluctuate always in a direction consistent with credit policy objectives.

Securities Department
Federal Reserve Bank of New York
March 5, 1956