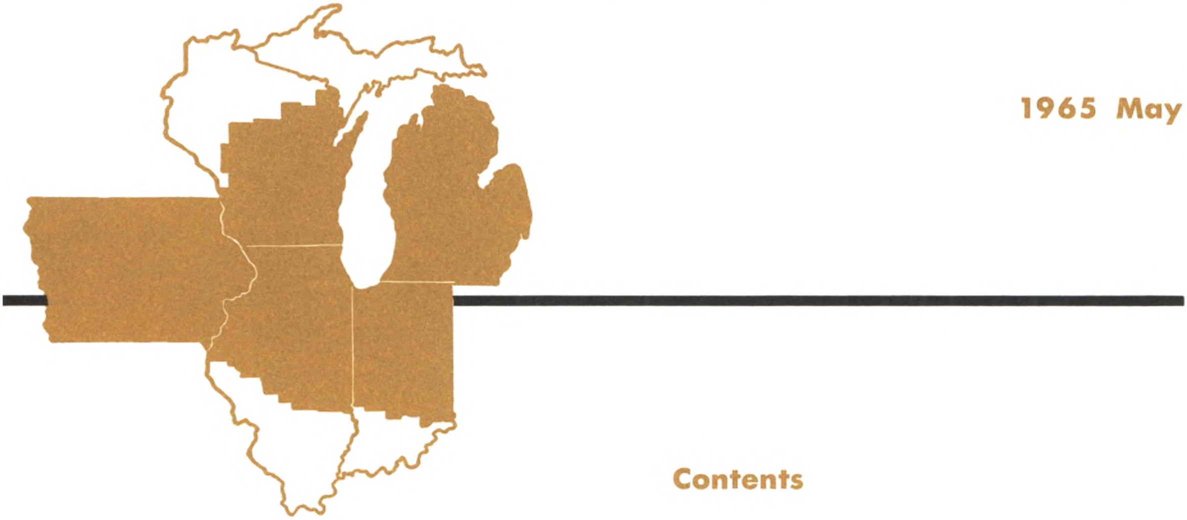
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1965 May

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CREDIT CARD
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Patterns of private debt growth

Does the level of private debt represent a threat to continuing prosperity? The growing financial liabilities of households and businesses, together with some evidence of declining credit quality, are drawing increased attention as the economy maintains its upward course.

At the end of 1964, *net private debt* amounted to 811 billion dollars—more than twice as much as ten years ago and five times the amount at the end of World War II. Individuals and businesses added an average of 34 billion dollars a year to debt during the decade of the Fifties. Boosted by additions of 64 billion dollars in 1963 and 58 billion in 1964, this average rose to 56 billion in the Sixties.

Debt has been an integral feature of growth of the American economy. As might be expected, debt has increased fastest in periods of rising business activity, such as in 1955 and 1959 and during the expansion of the past four years. During an upswing, business firms borrow to add to inventories and to plant and equipment, while consumers similarly are making use of credit to step up pur-

What is private debt?

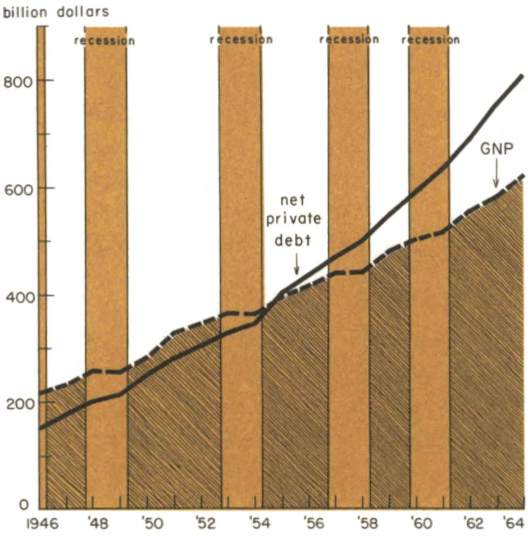
Net private debt is an aggregate of the indebtedness of households and businesses, after certain internally held corporate debt is eliminated to avoid double counting. It excludes the "deposit" liabilities of financial institutions and the indebtedness of governmental units.

The sections of this article describing household and business debt are based on statistics obtained from the sector statements of sources and uses of funds, which are part of the flow of funds accounts published by the Board of Governors of the Federal Reserve System.

Household debt consists largely (about 67 per cent) of residential mortgages. Consumer credit, including short- and intermediate-term consumer instalment and noninstalment credit, accounts for over 25 per cent of household debt obligations. The remainder is shared equally by security credit (funds owed to securities dealers and bank loans for purchasing securities) and "other" loans, mainly on insurance policies.

Business debt has two major components—mortgages on business property and bonds. These account for 30 and 27 per cent of the total, respectively. Bank loans represent about 20 per cent of business debt and the remainder is composed of trade debt (the funds businesses owe to one another) and "other" loans (principally loans from the U. S. Government and commercial loans from finance companies).

Private debt has expanded faster than economic activity in the postwar period



chases of goods and services.

In acknowledging the close relationship between growth of debt and expansion of economic activity, many observers are quick to point out some hazards. As debt swells, repayments and interest costs also rise. If such obligations grow faster than income, it is alleged, they may eventually become a drag on the economy. Others fear rapid and continuous credit expansion ultimately will lead to deterioration in the quality of the indebtedness and this, in turn, will set the stage for debt liquidation and a downward spiral of prices and activity.

In a free enterprise economy, loan terms and interest rates are determined largely by market supply and demand. As financial institutions search for productive investment outlets for their funds, competition may lead to relaxation of credit standards, possibly causing some extension of loans on inadequate collateral or to borrowers having insufficient income. Finally, there is some concern that the growth of debt resulting from the expansion of bank credit—the creation of new money—may overstimulate spending and lead to price inflation. The Federal Reserve System, in supplying the reserves upon which the quantity of bank credit ultimately rests, performs a delicate balancing act in striving to accommodate healthy economic needs without placing undue upward pressure on prices.

Debate over debt

As the level of debt rises, the debate over its implications grows more intense. Disagreement comes as an inevitable consequence of the perplexing combination of roles played by debt in its relationship to economic activity. In this respect, it is always a useful reminder that debt has another face. Every debt obligation of a borrower appears also as a credit asset to the lender. The nation's huge accumulation of debt, therefore, can be viewed just as well as a massive stock of financial assets. Thus, at the end of last year, holdings by the "public" (households and nonfinancial businesses) of liquid assets that were debts of others totaled over 1 trillion dollars. If 514 billion dollars in shares of corporate stock is included, overall financial asset holdings by the public would total more than 1.5 trillion dollars.

The gain in financial asset holdings was 68 billion dollars in 1964 alone. In good part, the reason for this growth of assets was a sizable write-up in the prices of stocks, now at their highest level in history. Since over one-third of the public's total financial assets is in the form of stocks, a drop in the market would change the picture.

Moreover, those who have incurred debts are not necessarily owners of the assets. Some are predominantly debtors, while others, on balance, are creditors. Studies by the Survey Research Center of the University of Michigan in 1963 indicate that 41 per cent of the families that had less than $500 in liquid assets owed at least that much in instalment debts. In contrast, only a fourth of the families that had accumulated $2,000 in savings had any instalment debt at all.

Perspective on debt is sharpened when comparison is made not only with the growth of financial assets but also with production and income. At the end of 1964, net private debt was 130 per cent of gross national product, up from 96 per cent ten years earlier and 73 per cent in 1946. While gross national product has increased at an average annual rate of 6 per cent since World War II, net private debt has risen at a rate of 10 per cent a year.

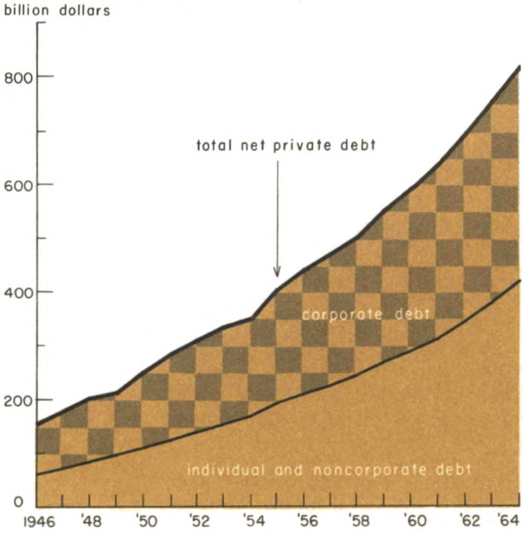
The ratio of private debt to gross national product is still below the high levels attained before the debt liquidation of the depression years. In 1929, for example, private debt was 154 per cent of gross national product. Whereas debt declined along with the drastic decline of business activity during the early Thirties, postwar recessions have not always been accompanied by corresponding reductions in debt. When gross national product declined during 1954, net private debt continued to expand, although at a slightly reduced pace. Despite the pauses in business activity in 1957-58 and 1960-61, debt grew 7 and 8 per cent in 1958 and 1961, respectively. Some useful impressions may be gained by examining the components of aggregate debt—its maturity distribution within the business and personal sectors, and its growth in relation to the investment expenditures by these sectors.

One important change in the composition of debt in the postwar years has been the rise of the share owed by individuals and unincorporated businesses. Together, these sectors accounted for over half the outstanding net private debt in 1964, up from 40 per cent in 1945. Between 1945 and 1964, their combined borrowings expanded at an average rate of 11 per cent a year, somewhat faster than debt of business corporations.

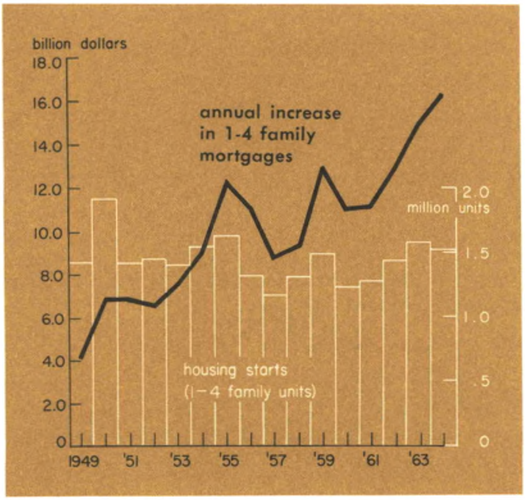
Household debt

While the rise in debt of unincorporated enterprises has been substantial, recent interest has centered primarily on households. To their debt has been added an annual average of 15 billion dollars since 1950. But since

Major sectors of private debt have increased sharply in postwar years



Mortgage debt has risen faster in recent years than investment in new residential construction



1960, such debt has risen at a rate of 20 billion dollars a year.

Well over two-thirds of the 23 billion dollar increase in household obligations in 1964 represented additional mortgage debt. This type of borrowing, secured by one-to-four family dwelling units, has grown steadily since 1950 when it represented only half of the 12 billion dollar rise in total household debt. Recent growth in home mortgage debt is particularly impressive when contrasted with the relative stability of new residential construction.

Helping to account for these dissimilar growth patterns are higher construction costs, declining down payments and longer terms—all entailing larger mortgages in relation to property values. Growing activity in the sales of used houses and their rising average prices have been other factors. In addition, there has been some evidence of a rise in the volume of mortgage borrowing on homes for nonhousing purposes. Many homeowners who have reduced their mortgage balances over the years have borrowed to finance household improvement projects, educational and travel expenses and for numerous other purposes by using the equity in housing as security.

The substantial growth in the volume of outstanding mortgage debt has focused particular attention on the quality of such loans. Numerous reports have been heard in recent years that loan standards have undergone appreciable relaxation. The size of loans has risen relative to the value of properties and the terms to maturity have lengthened. Together with the comparatively stable real estate prices of the past few years, the slimming of down payments and stretch-out of loan terms served to slow the accumulation of equity by the average borrower.

As an indication that home buyers have experienced growing difficulty in handling their mortgage obligations, foreclosures have advanced steadily in the past few years reaching 100,000 in 1964. The foreclosure rate was 4.59 per 1,000 mortgages last year —up from 2.34 in 1959 but still below the levels prior to World War II.

The patchwork nature of reports and evidence on mortgage credit quality scarcely supports hard-and-fast conclusions. Because credit deterioration is a slow, cumulative process which is difficult to measure, the results of imprudent lending today may not be evident for some time to come.

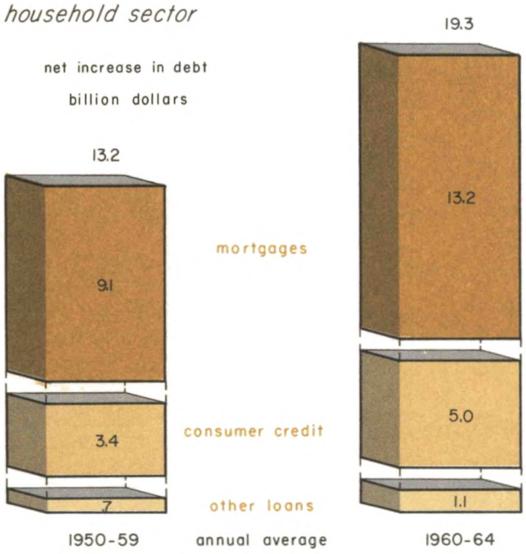
Although consumer credit accounted for less than one-third of the increase in total household debt in 1964, there has been widespread concern over its growth and its present-day "soundness." It is the nature of this debt to ebb and flow with the economy. But, net growth of consumer credit since 1960 has averaged 5 billion dollars a year, far outstripping the 3 billion dollar average during the Fifties.

A large proportion of consumer credit (about three-fourths) represents instalment borrowing to buy automobiles and other durable goods. Four consecutive years of strong automobile sales have led to a 38 per cent increase in outstanding automobile paper since 1960. Personal loans (about one-fifth of the total) rose 50 per cent in the same period. Traditionally employed to finance unexpected or unusually large expenditures, these loans are more and more frequently a source of funds for meeting educational and travel expenses, debt consolidation and home improvement projects.

In spite of large percentage gains, the growth of consumer credit has been moderate relative to household "investment" outlays during the current expansion. The ratio of consumer credit extensions to expenditures for durable goods remained between 11 and 12 per cent from 1962 through 1964, compared with 16 per cent in 1952 and 1955 and 15 per cent in 1959. More important, the ratio has increased only moderately from its low in 1961 compared with sharp gains in earlier expansions. In 1964, repayments on consumer instalment credit exceeded 60 billion dollars and required about 14 cents of the average dollar of disposable income; this ratio moved above 12 per cent in 1955 and hit 13 per cent in 1960—widely believed at the time to constitute a "ceiling." Much of the rise can be explained by an increase in the proportion of consumers incurring this type of debt. It appears that the volume of repayments has so far failed to limit the willingness or ability of consumers in the aggregate to add to their debt.

Because of the very rapid rise of residential mortgage debt in recent years, total household debt has increased more than total investment by households in residential structures and consumer durables.

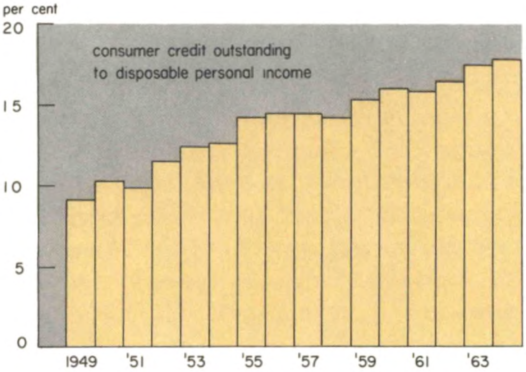
Debt of the household sector rose rapidly in recent years



Sources and uses of business debt

Nonfinancial businesses owed about 25 per cent more debt than households at year-end 1964, but the relative importance of business borrowing generally has declined in the postwar period. Businesses added to their debt at an annual rate of 8 per cent from 1945 to 1964, considerably below the growth rate of consumer debt. In the past few years, business borrowing has been noted for the stability of its growth in contrast to the turbulent changes throughout the Fifties. The "new look" has been accompanied by a realign-

Consumer debt has grown relative to disposable personal income

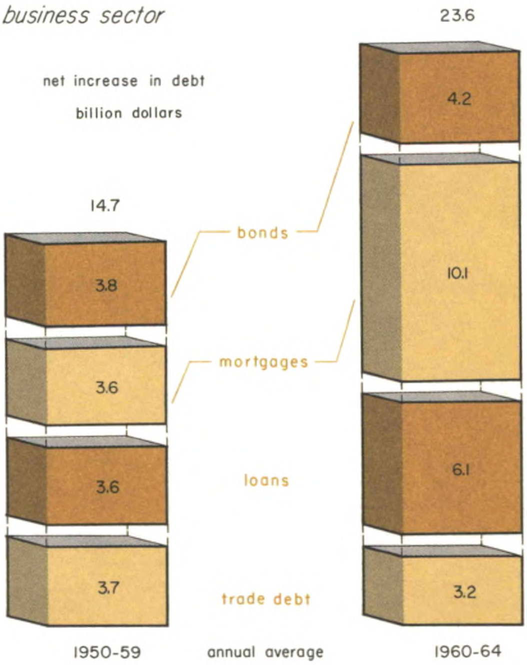


ment in the traditional uses of business funds.

During the Fifties sharp fluctuations in business investment spending accompanied the ups and downs in overall activity. Whether shifts in business spending are a cause or effect of changes in general business conditions (or, for that matter, whether the relationship works both ways) long has been debated. Whatever the relationship, past experiences suggest that within a sustained term of economic expansion, business investment may "over-reach" itself, providing additions to productive capacity that dampen investment expenditures for some time thereafter. Fears of a similar development in the current expansion have been mitigated by the moderation of the growth in business expenditures over the past four years.

Business capital spending during that period has been partly financed through large additions to debt. Net new borrowings have averaged 18 billion dollars a year since 1950 but reached 26 billion in 1962 and 29 billion in both 1963 and 1964. While business debt in the aggregate expanded 29 per cent between 1961 and 1964, mortgage debt owed by business firms climbed 49 per cent. Following a steady increase throughout the decade of the Fifties, nonfinancial businesses incurred an unusually large amount of mortgage debt in 1962, 1963 and 1964. Borrowings secured by mortgages exceeded 116 billion dollars at the end of 1964—two and one-half times the level in 1950. This growth was propelled by the recent boom in construction of apartment and office buildings, hotels and motels and shopping centers. Annual expenditures on residential and commercial construction by nonfinancial busi-

Debt of the business sector has risen more rapidly since 1960 than in the Fifties



nesses have almost doubled since 1961. In the past year, construction of this type has leveled off as overbuilding in some areas has led to a decline in expected returns.

Outstanding corporate bonded debt has increased 22 per cent since 1960, with additions averaging 4 billion dollars a year. Bond financing, an equal partner with mortgages as a source of long-term funds in the Fifties, has been less significant during the current expansion.

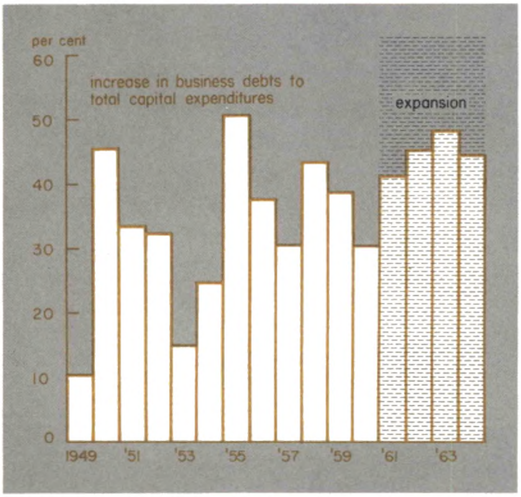
Bank loans to nonfinancial businesses have expanded 40 per cent since 1960, but banks have been a somewhat less important source of credit than in the Fifties. The 8 billion dollar increase in 1964 was large in comparison to earlier years, but it represented 28 per cent of their net increase in debt, compared with 32 per cent of total new debt in 1951 and again in 1956. The growth of trade debt—chiefly accounts payable—has also been less volatile during this expansion. Although additions to this type of debt have continued to be large in recent years, they have not been as large a proportion of the increase in total debt as in some earlier expansions. Moreover, the rate of advance declined substantially during 1964.

Despite the steady climb in commercial and industrial mortgage debt, total business borrowings in this expansion have still remained lower in relation to capital expenditures than they had been in 1955. The improvement reflects the comparatively moderate increase of short-term borrowing in the form of bank loans and trade debt. An important reason for the reduced reliance on banks for financing has been the ample supply of internal funds available for business spending. Corporate retained earnings and depreciation allowances have risen steadily for four years, boosted by strong sales increases, higher profits, liberalized depreciation allowances, the investment tax credit and reductions in Federal income tax rates.

Businesses have borrowed more in mortgage credit than any other form

Sources of business debt	Share of net increase 1950-59	1960-64
	(per cent)	
Bonds	26	18
Mortgages	24	43
Bank loans	20	19
Trade debts	25	13
Other loans	5	7
Total	100	100

Business debt increase since 1961 has held close to 45 per cent of annual capital expenditures



Bankers' acceptances used more widely

The volume of bankers' acceptances outstanding in the United States has grown substantially in recent years, reaching 3.4 billion dollars at the end of 1964—four times as great as a decade earlier. After years of decline in the Thirties and Forties, the acceptance once again, as in the Twenties, is playing an important part in trade financing.

Types of bankers' acceptances

A banker's acceptance is a time draft or bill of exchange drawn on a bank—normally by an importer, exporter or other trader. It calls for a payment of a specified amount at a specified future time (usually in 30, 60 or 90 days) and bears a certification of "acceptance" by the bank on which it is drawn. Generally speaking, acceptances are a form of commercial paper, but unlike conventional paper are identified with individual transactions involving commodities either in storage or in transit.

Regulation C of the Board of Governors of the Federal Reserve System authorizes member banks to accept drafts[1] that arise from international transactions—such as exports, imports, shipments of goods between other countries, and storage of marketable staple commodities in the United States and in foreign countries—and with Board approval for certain countries drafts that are not directly related to merchandise transactions but merely create dollar exchange for a foreign country to finance its trade with another country.

More than half the acceptances outstanding at the end of 1964 arose from the United States merchandise imports and exports. While during the past decade the dollar volume of trade transactions has almost doubled, the use of acceptances to finance them has increased two and one-half times. It is estimated that about 15 per cent of United States foreign trade in 1964 was financed through the acceptance credit.[2]

Nearly one-half of the acceptances outstanding in 1964 arose from financing goods stored in foreign countries—up from only 10 per cent at the end of 1954. On the other

[1] A member bank may not extend acceptance credit of more than 10 per cent of its paid-up and unimpaired capital and surplus to any one borrower; the total amount of accepted drafts may not exceed—unless authorized specifically by the Board of Governors—50 per cent of the unimpaired capital and surplus. When acceptances arise from domestic trade, the bank is required to have "physical possession" of the shipping documents conveying the title to these goods.

[2] This estimate is based on the assumption that the average maturity of a trade financing acceptance is three months.

How acceptances are born

Acceptances may originate in any of several ways. The most common is through a *letter of credit.* The following hypothetical example illustrates the basic elements.

A firm in Decatur, Illinois, agrees to sell to a company in Frankfurt, Germany, a certain quantity of soybean oil. If the agreement calls for payment in cash upon shipment, the German company may arrange with its banker in Frankfurt to issue a letter of credit authorizing the Decatur firm to draw a *sight draft* that may be presented for immediate payment at an American bank—say, in Chicago—with which the bank in Frankfurt regularly does business and has standing arrangements for such transactions. If the agreement calls for payment at some future date, the letter of credit will authorize the drawing of a *time draft* on the Chicago bank, and when "accepted" will represent its obligation.

The Decatur firm may hold the draft until maturity and then submit it for payment at the Chicago bank through its bank in Decatur. Alternatively, if the firm wishes to obtain funds immediately, it may present the draft at the Chicago bank and receive from it the face value of the draft minus the discount prevailing in the market. The bank may hold the bill until maturity and then submit it through its correspondent bank in Frankfurt to the German company for collection. Alternatively, the Chicago bank may affix evidence of its own readiness to pay the bill at maturity by either stamping "accepted" on the face of the bill or by attaching a formal statement to that effect, thus giving the instrument legal status as a negotiable money market instrument—the banker's acceptance—that may be sold on the market.

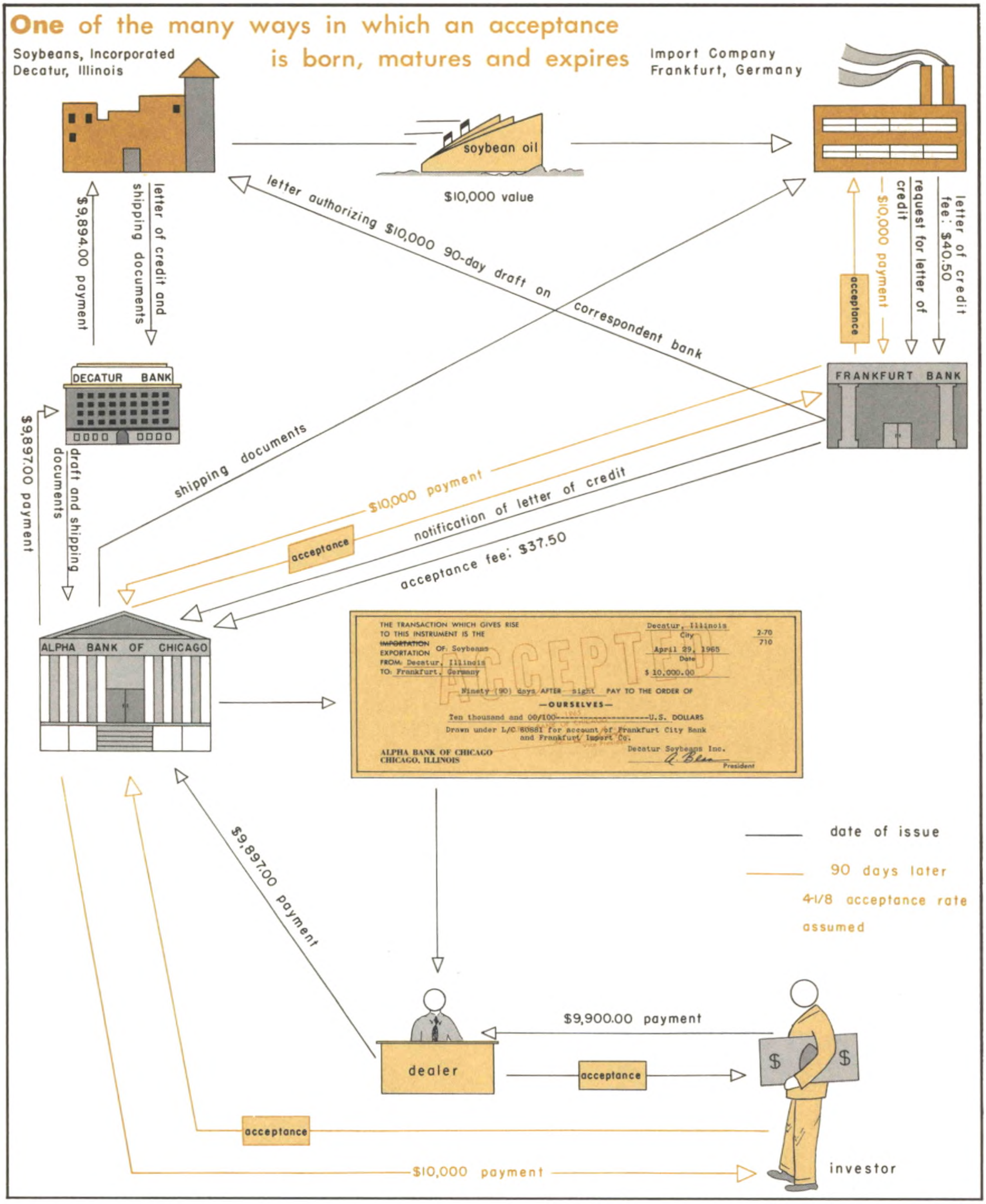
In a case where the acceptance credit is used for import financing, the process may be the following. At the request of the importer (the Decatur firm) the bank in Decatur issues a letter of credit authorizing the German exporter to draw a draft on the Decatur bank's correspondent in Chicago. The bill may then be discounted by the German company at a local bank which forwards it to the Chicago bank for acceptance. The Chicago bank may then hold the bill for its own account or sell it through a dealer to someone desiring to hold the instrument to maturity.

hand, the use of acceptances to finance goods stored in or shipped between points in the United States has declined from about one-third of the total at the end of 1954 to a negligible proportion at year-end 1964.

Historical background

A bill of exchange (a draft drawn on the purchaser by the seller of goods) and its more sophisticated form, the banker's acceptance, are virtually as old as international trade itself. The earliest known bills of exchange date from 1156 but it is believed that their initial use dates back to the Roman or Byzantine Empires. The development of bankers' acceptances as a form of commercial credit and a means of money transfer by banking houses of Florence, Genoa and Venice in the thirteenth century initiated an era that commonly is referred to by historians

One of the many ways in which an acceptance is born, matures and expires


Soybeans, Incorporated
Decatur, Illinois
Import Company
Frankfurt, Germany
soybean oil
$10,000 value
letter authorizing $10,000 90-day draft on correspondent bank
$9,894.00 payment
letter of credit and shipping documents
letter of credit fee: $40.50
request for letter of credit
$10,000 payment
acceptance
DECATUR BANK
FRANKFURT BANK
$9,897.00 payment
draft and shipping documents
shipping documents
$10,000 payment
acceptance
notification of letter of credit
acceptance fee: $37.50
ALPHA BANK OF CHICAGO
$9,897.00 payment
dealer
$9,900.00 payment
acceptance
investor
acceptance
$10,000 payment
date of issue
90 days later
4-1/8 acceptance rate assumed

THE TRANSACTION WHICH GIVES RISE TO THIS INSTRUMENT IS THE ~~IMPORTATION~~ EXPORTATION OF: Soybeans
FROM: Decatur, Illinois
TO: Frankfurt, Germany

Decatur, Illinois
City

2-70
710

April 29, 1965
Date

$ 10,000.00

ACCEPTED

Ninety (90) days AFTER sight PAY TO THE ORDER OF

—OURSELVES—

Ten thousand and 00/100---------------------U.S. DOLLARS

Drawn under L/C 80881 for account of Frankfurt City Bank
and Frankfurt Import Co.

ALPHA BANK OF CHICAGO
CHICAGO, ILLINOIS

Decatur Soybeans Inc.
A. Blan
President

as the "commercial revolution."

Since then, the bankers' acceptance has played an important role not only in facilitating the financing of trade among nations but also as a means of arranging transfers of short-term capital between countries.

It was through the medium of bankers' acceptances that central banks traditionally exerted influence on the balance of international payments and domestic economic conditions. For example, if a country was subject to a gold drain due to a deficit in its balance of payments, an increase in the acceptance rate would help to correct the situation by attracting foreign funds to the domestic market and by causing acceptance borrowers to shift to other national markets. Central banks influenced the acceptance rate at which both domestic and international trade was financed by changes in their discount rates, thus affecting the cost and availability of credit. Prior to 1914, central banking decisions to exert such pressures were guided greatly by international developments and the gold reserve position of the country.

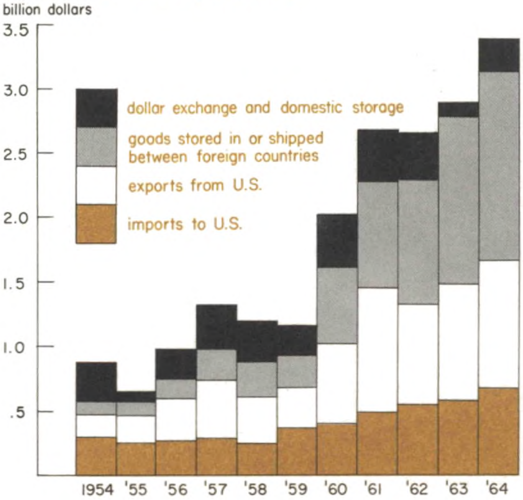
Development of acceptances' market

Through the nineteenth century, and until World War I, the London money market was the center of the international exchange system. American foreign trade prior to 1914 was financed largely by drawing bills on London banks. The financial institutions in the United States were not so well-known as were the London firms, nor were they generally so well-equipped to accommodate the financing of international trade. More important, there was no central bank that could assure liquidity and ready convertibility of currency into gold—a feature necessary for attraction of foreign short-term funds. Furthermore, national banks and banks chartered in many of the states were not permitted to accept bills of exchange arising from international trade transactions. The small volume of dollar acceptances was issued largely by private banks.

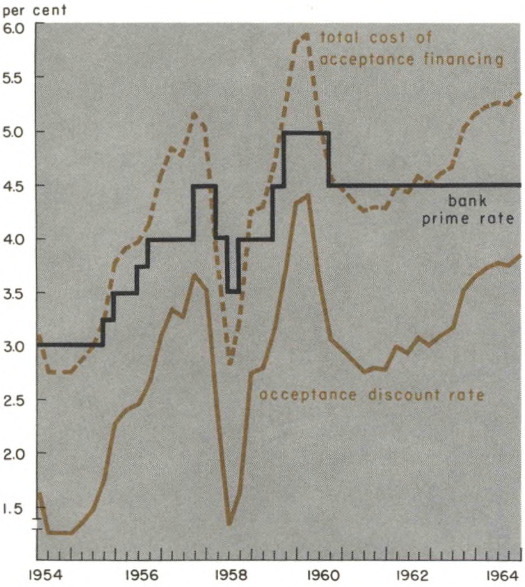
Provision for growth of the acceptances' market in the United States was one of the main features of the Federal Reserve Act. The act provided for discount of acceptances by Federal Reserve Banks and authorized member banks to accept drafts and bills of exchange.

There were two major reasons for the desire to establish an acceptance market in the United States. First, it was believed that it would be desirable to substitute the bankers' acceptance market for the brokers' loan market which, up to that time provided the secondary reserve assets for commercial banks. In accordance with the banking theory prevailing at that time, paper which was based on specific transactions arising from trade—

Transactions financed by United States bankers' acceptances



Rates on prime commercial loans and bankers' acceptance compared



and, therefore, self-liquidating—was considered preferable for bank investment to inherently speculative loans associated with security trading or financing of long-term capital investments. Second, it was believed that the development of a bankers' acceptance market would be consistent with the emerging creditor position of the United States internationally.

The first acceptance by a national bank in the United States was made by the National City Bank of New York on September 4, 1914. Reflecting the increase in foreign trade during and after World War I, and the support of the market by the Federal Reserve System, the volume of acceptances increased rapidly reaching 1 billion dollars by 1920. During the recession of 1920-21, volume declined sharply. Not until 1927 did the volume outstanding again reach 1 billion dollars. In 1929 the volume of acceptances outstanding reached 1.7 billion dollars—a level not equaled until 1960.

Cost of acceptance financing

The cost of acceptance financing is made up of two parts. The accepting bank usually charges a commission of 1½ per cent a year (⅛ of 1 per cent a month) for assuming the credit risk. This charge may vary, according to the bank's evaluation of the risk involved. In some cases, as when the customer is a correspondent bank, the commission may be lower. The second part of the cost is the discount from face value at which the acceptance may be sold on the market—the buying rate quoted by acceptance dealers.[3]

The dealers are essentially the intermediaries between sellers and buyers, purchasing acceptances outright from holders seeking to dispose of them and selling to those seeking to purchase them. But dealers attempt to operate with a minimum portfolio. To achieve this they adjust their buying rate according to anticipated demand and supply conditions as well as the cost of financing. This portfolio position is usually financed largely by call loans from commercial banks and, on occasion, through repurchase agreements with the Federal Reserve Bank of New York. Thus, the dealers' buying rate is affected by many forces, all closely linked to conditions in the money market.

Dealers derive their profits largely from

[3] The daily quoted rate is that on prime acceptances. The rate may differ somewhat depending on the "name" of the accepting bank. There are five dealers in bankers' acceptances, all located in New York City; all except one also deal in other money market instruments. See *Monthly Review,* Federal Reserve Bank of New York, June 1961.

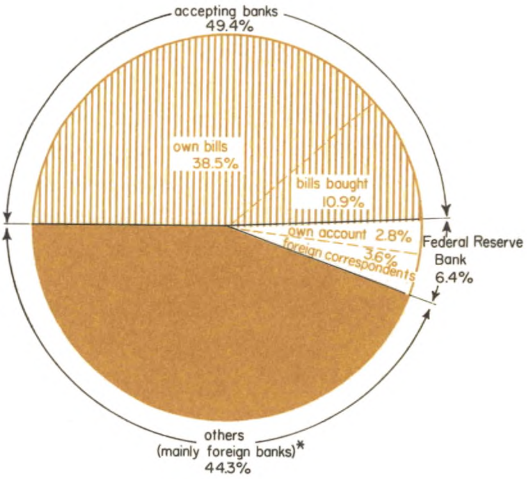
the ⅛ of 1 per cent spread between buying and selling rates rather than from holding a portfolio. The requirement, particularly on the part of foreign purchasers of acceptances, that the acceptance bear the endorsement of two banks assures dealers of a substantial volume. Thus, mostly to accommodate foreign correspondents, the issuing banks engage in what is known in market terminology as "swaps"— they exchange, through dealers, acceptances bearing their own endorsement or "acceptance" for the drafts accepted by other banks, and add their own endorsement to them. There is a charge of ⅛ of 1 per cent commission to the dealer for such endorsement.

On April 6, for example, when the prime acceptance offering rate of dealers was 4⅛ per cent, a prime acceptance borrower would pay 5⅝ per cent annual rate on a 90-day acceptance credit from his bank (that is, 1½ per cent commission plus 4⅛ per cent discount; for longer maturities this discount is somewhat higher—by ⅛ per cent up to 120 days and an additional ⅛ of 1 per cent up to 180 days). The bank would sell its acceptance to a dealer at a price to yield 4⅛ per cent and buy back acceptances of other banks at 4 per cent; after adding its endorsement the bank might then sell these to its foreign correspondents priced to yield 3⅞ per cent.

The market in acceptances

Compared with other money market instruments such as Treasury bills or commercial paper, the market for bankers' acceptances is narrow. The bulk of outstanding acceptances has been held by the accepting banks—mostly their own bills—and by foreign banks. A small portion is held by the Federal Reserve for the account of foreign correspondents and for its own account.

Holders of acceptances as of December 31, 1964



total amount - $3,385 million

Although comprehensive data on acceptances held by domestic investors other than banks are not available, it is generally believed that such amounts are small. This arises from several factors, related mostly to the institutional makeup of the market. First, since the maturities and denominations of acceptances are geared primarily to the needs of individual transactions on which they are based, the instrument is less suited to meet the liquidity needs of domestic investors than are other readily available short-term assets such as Treasury bills and commercial paper. Furthermore, the yield differential between acceptances and other instruments has not always been adequate to overcome this inconvenience.

Second, the accepting banks have traditionally used a large portion of the supply of acceptances to accommodate the demand of their foreign correspondents. The demand for acceptances for this purpose has in many instances exceeded the supply so that only a limited supply has been available for sale through dealers' to the general public.

For foreign investors and banks, acceptances are attractive assets. The limited amount of other short-term assets available in their relatively undeveloped money markets, and in some instances, legal restriction upon holding foreign government treasury bills as reserve assets—combined with long tradition and familiarity with acceptances—have maintained an active demand for United States acceptances. Until May 1961, an additional attraction was the fact that income of foreign central banks from this source was not subject to the United States income tax. This advantage, however, was eliminated when an amendment to the Internal Revenue Code exempted all income of foreign central banks from United States income tax.

Advantages of acceptance financing

To an individual bank, extension of credit through acceptances has certain advantages over an ordinary business loan. First, the bank can accommodate its customers' credit needs without incurring any loss of reserves since the acceptances may readily be sold in the market. When the bank sells acceptances, it realizes only the 1½ per cent commission (as opposed to the commission and discount if the acceptances are held to maturity), but the bank can thus "lend its name" even when "loaned up." Although the bank's acceptances outstanding, whether sold or held, are a contingent liability, the bank can accommodate its customers while conserving its cash. Furthermore, even if held by the accepting bank until maturity, acceptances may be considered a more liquid asset than ordinary loans since they are readily marketable.

From the viewpoint of the borrower, acceptance financing, in some instances, may have advantages over direct loans. The rate on acceptances for prime borrowers has been higher since 1963 than the prime rate at which conventional, unsecured loans are available. But this spread cannot be taken as an exact measure of the difference in cost of financing by these means. Firms that would not qualify for the prime rate on commercial loans may qualify for the 1½ per cent commission as an acceptance borrower. Furthermore, the acceptance credit requires no "compensating balance" such as may be required on conventional loans to commercial and industrial borrowers.

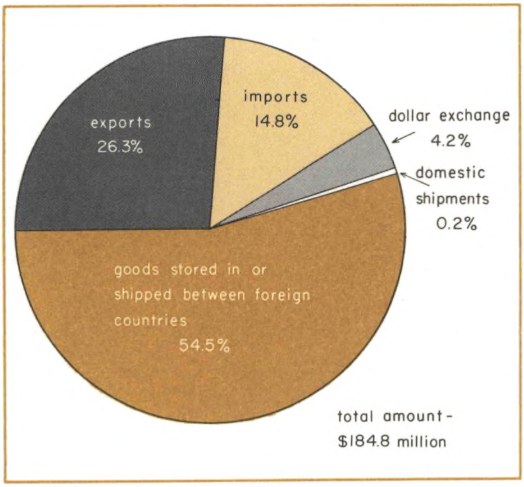
From a broader viewpoint, the development and use of acceptances have greatly facilitated international trade. Their use makes it possible for two traders relatively unknown to each other to undertake commercial transactions.

Acceptance financing in the Midwest

Only a few of the commercial banks in the United States act as accepting banks, and most of these are located in New York City. About 75 per cent of all acceptances generated in this country originate there. However, acceptance financing in the Seventh Federal Reserve District has increased more rapidly than the total volume nationally.

At the end of 1954 there were about 18.5 million dollars of acceptances outstanding that originated in the District—about 2 per cent of the total; in December 1964 the volume was almost 185 million dollars—about 5.5 per cent of the total. This increase in the District's share of the total outstanding reflects the growing importance of the Midwest in American international trade and finance.

Acceptances outstanding in the Seventh District by type of transactions



The origin of these acceptances by type of transaction is shown in the accompanying chart.

Conclusion

The growth of bankers' acceptances in the United States in recent years has been an important development in the financing of American international trade. On one hand, it has facilitated financing of trade by banks in periods of both monetary ease and tightness and contributed to the development of United States money markets as international financial centers. On the other hand, the growth of dollar acceptances has provided foreign investors with increasing amounts of attractive investment assets—thus helping to strengthen the position of the dollar as a reserve currency.

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