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To Members of the Federal Open Market Committee and Presidents Not Currently Serving on the Committee

May 17, 1965

From Alan R. Holmes

Subject: Third Country Acceptances Held by the Federal Reserve Bank of New York

At the Committee's request, consideration has been given to the feasibility of developing a System approach to the bankers' acceptance market that would serve to de-emphasize third country acceptances, i.e., to prevent any increase in, and perhaps to reduce, the proportion of Reserve Bank holdings represented by third country paper. The purpose would be to avoid any suggestion of inconsistency between System operations in the market for bankers' acceptances and the current Voluntary Credit Restraint Program. Recent statistics reported to the Committee indicate that the Reserve Bank's combined holdings of acceptances for own account and for account of foreign correspondents include roughly the same proportion of third country acceptances as does the total of dollar acceptances outstanding for the country. Such a relationship, while coincidental, is a reflection of the fact that the Reserve Bank's portfolio represents a good cross section of acceptances in the market. Nothing would be gained, of course, by effecting a reduction in holdings of third country acceptances for the Reserve Bank's own account merely by diverting new purchases of such paper into foreign account holdings. Indeed, no one outside the System knows what types of acceptances are included in the portfolio.

There appears to be no way in which the Reserve Bank can discriminate against a particular type of acceptance unobtrusively. In accordance with long-standing practice, daily purchases of acceptances are accomplished by placing orders with each dealer for specified amounts of "prime eligible bankers' acceptances". No stipulation is made as to the types of acceptances to be included and the dealers have had no occasion to consider the types of transactions represented in the packages of bills delivered to us, except from the standpoint of eligibility. If, after examination, it is necessary to return any acceptances as ineligible or nonnegotiable, the reason for such action is given to the dealers by the Reserve Bank. Should acceptances be returned on the grounds that they were created to finance third country trade, the dealers would immediately become aware that such paper had limited or no acceptability to the Reserve Bank. Such information would be quickly passed on to accepting banks and to investors. This would be the case whether third country acceptances were all or only partly returned. Eventually it would probably be necessary, as a practical matter, to tell the dealers that only a certain proportion of the acceptances they sold to the Reserve Bank could represent third country trade.

It is hard to predict what might be the result of an overt discriminatory policy. At the one extreme, the market might take it lightly. The banks would then continue to create third country acceptances as before, selling them directly to customers or to dealers. The dealers, in turn, would simply divert them to other customers and sell to the Reserve Bank only those acceptances which did not finance third country trade. This would accomplish nothing from the standpoint of discouraging third country financing, but would, rather, make a mockery of the effort.

It is much more likely, however, that discrimination by the Reserve Bank would be taken very seriously by the market. News that third country acceptances had limited acceptability to the System would probably cause other buyers, particularly banks and certain investors whose investments are circumscribed by law, to avoid this type of paper. There might even be some confusion regarding the question of eligibility versus acceptability of third country acceptances so that some banks would hesitate to sell any third country acceptances into the market, if indeed they continued to create such paper. Other banks would probably cut back on third country acceptance financing much more drastically than would be contemplated or desired by the Committee. Given the relatively large ratio of third country acceptances to total acceptances outstanding, it appears likely that there would be serious repercussions in the acceptance field. Moreover, the recent analysis of Reserve Bank holdings distributed to the Committee on May 6, 1965 indicated that about 70 per cent of third country acceptances held involved the financing of Japanese trade, which is granted special consideration under the guidelines of the Voluntary Credit Restraint Program.

Conceivably, the reaction could be somewhere in between the extremes mentioned above. The market would continue to function, but third country acceptances would be under somewhat of a cloud which might even be reflected in a higher market rate for third country paper than for other types of acceptances. Dealers, accepting banks, and investors would then have to make a continuous judgment as to what extent this was so and would have to keep a constant outlook for any change, in either direction, in the degree of disfavor on the part of the System. There might also be some concern lest the System discriminate against other types of acceptances, for example, those financing imports or dollar exchange.

Discrimination of any kind would be complicated by the necessity of making fairly large daily purchases for account of foreign correspondents. In view of the large proportion of outstanding acceptances that arises from third country trade, the foreign account orders could probably not be filled without taking a moderately large amount of third country acceptances. In order that the daily buying be handled most efficiently, dealers would have to be told what accounts are involved, information which they do not currently have. They could then channel third country acceptances into the foreign account orders and fill orders for the Reserve Bank's own account with other types of acceptances. This could reduce the effectiveness of any discriminatory program.

Bankers' acceptances of all types, created on behalf of foreigners, are included within the 105 per cent limitation imposed by the Voluntary Credit Restraint Program. The guidelines have already suggested that credits to finance third country trade are an appropriate area for curtailment, although certain countries are given special treatment. If the Committee feels that more persuasive action to discourage third country acceptances is desirable, it would appear appropriate, as has been previously suggested, that it be accomplished by revising the guidelines of the Voluntary Credit Restraint Program rather than by interfering with market processes. Direct action by the System to discriminate against third country acceptances in the market would very likely be construed as a departure from the voluntary character of the program. Moreover, since such action could not be undertaken unobtrusively, it could have a long-lasting adverse effect upon a market which the System has sought to encourage for many years.