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A-917 LIMITED OFFICIAL USE SUBJECT

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Department of State

INFO : Brasilia, Belém, Recife, Salvador, Belo Horizonte, Sao Paulo, Curitiba, Porto Alegre

Amembassy RIO DE JANEIRO April 18, 1967

Central Bank Sells Bonds to Absorb Excess Bank Liquidity

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Summary

1. The Central Bank initiated on April 3 a program of Treasury bond sales to commercial banks in order to absorb excess bank liquidity without the necessity of increasing compulsory reserve requirements. The Central Bank had sold NCr$59.6 million of bonds to commercial banks by April 10; Rui Leme has stated privately that he has a sales goal of NCr$100 million. Banks are acquiring the bonds under the umbrella of a repurchase agreement issued as Central Bank Circular 85, approved by the Monetary Council on March 31, 1967. The Central Bank guarantees repurchase after 30 days of series C (one-year-readjustable-6 per cent) Treasury bonds acquired by banks from the Central Bank after March 31, 1967.

2. The Authorities are hopeful that the combination of the bond sales, plus the threat of an increase in compulsory reserve requirements, will be sufficient to forestall a rapid expansion of bank loans for speculative and improductive purposes over the next several weeks. In the Embassy's view the Circular 85 program being implemented is not sufficient to cope effectively with the present monetary situation for reasons outlined below and discussed in more detail in the body of this airgram: a) The amount of bond sales is small in terms of the magnitude of excess bank liquidity; b) the net impact is reduced by the acceptability of the bonds for partial fulfillment of compulsory reserve requirements; c) the repurchase agreement implies that the Central Bank will have to purchase the bonds

Attach.: Circular 85 (translation)

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in a very short period, at the option of commercial banks; d) there is no effective monetary incentive for banks to retain substantial amounts of bonds in lieu of more profitable alternative uses of funds; and e) bankers are unlikely to be restrained from mobilizing remaining excess reserves to support a loan expansion either for liquidity reasons or because they believe their own actions would cause the Authorities to raise reserve requirements for the whole system.

Discussion

3. Under the terms of Circular 85 the Central Bank will repurchase at subscribed value after 30 days series C (one-year-readjustable-6 percent) Treasury bonds acquired by banks from the Central Bank after March 31, 1967. The bonds are sold to banks at 98 percent of par, the 2 percent discount taking the form of a "sales commission". However, the Central Bank will repurchase the bonds only at the discounted value unless they are held to maturity. The interest earned is made to depend on the length of time the bonds are retained. The interest per month is 0.5 percent if the bonds are held one month; the interest per month increases by 0.1 percent for each additional month they are held -- the maximum is 1.0 percent per month for bonds held more than 180 days. Interest accrues only on a 30-day basis, so that, for example, a bank which sold the bonds to the Central Bank after 50 days would receive interest only for 30 days. The bonds will be accepted by the Central Bank for purposes of compulsory reserve requirements within established limits (up to 20 percent of total compulsory reserves). We were told privately by commercial bankers that the Central Bank indicated it would accept these bonds as collateral for a loan if banks found themselves short of cash before the minimum retention period had elapsed. Although not so stated in Circular 85, banks are free to sell these bonds in the market at any time.

4. The initiative shown by the Central Bank in attempting to develop a new tool of monetary control in Brazil is laudable. The Circular 85 program is not a true "open-market" operation, however, but a placement of securities with banks in circumstances where the major inducement apparently was derived from a threat of compulsory reserve increases rather than profitability, and where the Central Bank has guaranteed repurchase of the securities, at the option of banks, after 30 days. This program is a temporary expedient designed to reduce bank excess voluntary reserves sufficiently -- but not completely -- to forestall a rapid expansion of bank loans to speculative and improductive activities during the next few weeks until such time as the demand for agricultural loans picks up and funds flow to the interior for that purpose. The Authorities are counting heavily on the present operation temporarily sterilizing a greater amount of excess reserves than the NCr$100 million of bonds sold, because of the threat to increase reserve requirements if banks do not contain their loan expansion to prudent levels.

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5. We do not believe that the Circular 85 program being implemented can cope effectively with the present monetary situation. The current operation has many weaknesses both from the technical and psychological points of view, which can be summarized as follows:

a) Even if this were a true "open-market" operation, the anticipated sales of bonds is insufficient to contain bank credit expansion to moderate amounts. We estimate that by the first week in April commercial banks excess voluntary reserve holdings (currency and free deposits) -- and taking into account the very low liquid rediscount liabilities -- was on the order of magnitude of NCr$300 million, or about 3 times the amount of anticipated bond sales. The net impact would be even less, because banks would have purchased some of the bonds in partial fulfillment of compulsory reserves, which are due on April 20. We would estimate roughly that NCr$15-20 million of the bonds purchased under the Circular 85 scheme will directly substitute for bonds that would have been purchased during April, in any event.

b) This is not a true "open market" operation and does not have the same pervasive impact on bank liquidity. In a true open-market operation bonds would be sold to a large extent outside the banking system. The impact of bond purchases by the public would be an equivalent decline in bank deposits and bank reserves, with a consequent compression of bank liquidity; banks would have no liquid asset to replace the cash reserves lost. In the present program banks are, in effect, being paid a small yield on part of their excess reserves, which otherwise would yield nothing, but have not really lost much liquidity. Banks have given up some free reserve deposits (and/or vault cash) but have acquired what was made to be a very liquid asset by virtue of the Central Bank repurchase agreement and commitment to accept them as collateral for Central Bank loans; it is difficult to imagine that most bankers will feel much less liquid as a result. This does not appear to offer much of a shield against a sharp increase in bank loans (and, consequently, deposits) with a draw-down of remaining excess free cash reserves to finance the resultant increase in the compulsory reserve liability.

c) There is room for doubt as to whether even the portion of excess reserves represented by the (net) acquisition of bonds will be effectively "sterilized" for more than a short period. The bonds were sold to banks under threat of an increase in compulsory reserve requirements and not on the basis of an attractive yield, which is little more than one-half the rediscount rate, even if held for more than six months. While the interest rate goes up slightly if the bonds are held more than the minimum period, the additional yield is very small compared to the profitability of alternative uses of funds. Even if banks did hold on to the bonds for fear of reprisal from the Central Bank, the net impact would be reduced to zero in just a few months, during which time the bonds would substitute completely for bonds the banks would have purchased in the normal course of satisfying part of compulsory reserve requirements.

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d) The Authorities are likely to be disappointed with the impact on commercial banks of the threat to increase compulsory reserve requirements if they do not continue to hold substantial excess reserves -- over and above these invested in bonds -- rather than increasing loan expansion in response to the excess liquidity. It is difficult to imagine that most bankers would feel constrained to pass up profitable lending opportunities on the assumption that because of his own activities the Central Bank would increase compulsory reserve requirements for the whole banking system, which the Central Bank president has stated publicly he would not like to do. Indeed, the creditability of the Central Bank position probably was reduced by the fact that there was not even a token increase in compulsory reserve requirements in circumstances where bankers knew that their liquidity was at an impreecedented level.

6. The Authorities could have effectively sterilized all of the excess bank liquidity in the short run with an increase in compulsory reserve requirements well below the 10 percentage point increase allowed by Decree-Law 108. We estimate roughly that an increase of 3 percentage points (all payable in cash) in conjunction with the elimination of agricultural paper from compulsory reserves would have been sufficient, if made fully effective by the end of the second quarter (i.e., implemented in stages with the new ratio completely fulfilled by the end of June). The Authorities could then have reduced requirements somewhat as conditions might permit, but attheir option. One reason for not using the compulsory reserve tool, as stated to Embassy officers by Rui Leme, was the fact that not all banks had excess liquidity. It is true that this is an across-the-board device; however, it would seem to be administratively possible to give temporary reserve releases (or longer period for attainment of the new ratio) to those banks which could demonstrate that compliance with the staged increase would cause substantial hardship. In any case, the Central Bank would have to face up to this problem in any event if conditions forced it to make good its threat to increase reserve requirements. It is probable, however, that the major deterrents to the use of the compulsory reserve tool was a desire of the new government to show a new face to the private sector and to avoid any political difficulties which might result from such an action, even if it were announced as a temporary measure. The danger is that by not taking more effective action now it will be necessary to take an even harder action later, which could be much more disruptive to banks and to the economy; therefore, in the longer run the political difficulties may be increased because of the unwillingness to take effective, but unpopular measures at this time. There is a danger also that an ineffective response will serve to prolong the wishfull thinking of those still harboring expectations of fluid credit and continued high inflation.

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A-917
Enclosure
Rio de Janeiro

CIRCULAR No. 85

(translation)

To Banking Establishments:

We advise that the Central Bank, in accordance with a decision by the Monetary Council in today's session, guarantees the commercial banks that it will repurchase, initially through its agencies in São Paulo and Guanabara, National Treasury obligations - readjustable, one-year maturity, interest of 6% p.a., under the following conditions:

1) Only National Treasury obligations - readjustable originally acquired from the Central Bank and represented by series "C" certificates of 10, 50, 1,000 and 10,000 obligations will be repurchased;

2) A commission of 2% of the subscribed value will be advanced to interested banks at the time of their purchases;

3) The repurchase will be effected, at the option of the interested banks, in the same amount as the subscribed value, plus interest on the nominal value in force at the time of the subscription, as set forth in the table below:

	monthly interest	annual interest
after 30 days from subscription date	0.5%	6.0%
" 60 " " " "	0.6%	7.2%
" 90 " " " "	0.7%	8.4%
" 120 " " " "	0.8%	9.6%
" 150 " " " "	0.9%	10.8%
" 180 " " " "	1.0%	12.0%

note: the option to sell will be permitted only after the 31st day from the date of subscription and periods of less than 30 days will not be considered for the calculation of interest.

II. The obligations dealt with in this circular can be utilized for the payment of compulsory deposits as set forth in Resolution 5, of August 26, 1965.

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