

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM**Office Correspondence**Date January 16, 1940To Board of GovernorsSubject: The Inter-American bankFrom Mr. Goldenweiser
Mr. GardnerproposalRecommendation

In view of all the circumstances, political as well as economic, we are prepared to recommend that the Board support the idea of an Inter-American bank as well as legislation permitting the Federal Reserve System to subscribe to the capital of such a bank and participate in its management. On the basis of this readiness to act the Board could then institute conversations with the Treasury with a view to reaching an agreement as to what agency of the United States Government should represent this country on the bank.

Pros and cons of the bank

From an economic standpoint an Inter-American bank would face many obstacles to constructive action.

1. Unless the bank's investments of United States funds in Latin American countries helped them to develop their export business and acquire more dollars, it would find itself getting paid only at the expense of other United States creditors of these countries. With currencies of the belligerents blocked it will be difficult for Latin American countries to acquire dollars unless they can increase their sales of goods to the United States. Will the bank program go hand in hand with an effective trade program? The recent breakdown of the trade agreement negotiations with Argentina is discouraging from this standpoint.
2. Most Latin American governments that are borrowing abroad are now in default. Several are subject to overthrow by revolution. It is a question what their promises would be worth either on securities or on a guarantee against exchange blockage. While they might be willing to give preferred treatment to the bank in practice, as well as in law, there is a possibility of the bank being seriously embarrassed by repudiations of promises.

3. Because of the great geographical distances and the paucity of able financiers in many of the countries involved, there will be major difficulties in organizing and administering an effective, yet representative, bank.
4. The possibility of destructive competition with Latin American branches of United States banks would require attention. This possibility, however, should be minimized if the Inter-American bank operates only in dollars.

While these obstacles and limitations on an Inter-American bank's action are serious, a bank can be conceived which might do a useful job with reasonable safety, even though it would be a minor job from an economic standpoint. To do an adequate business the bank would need to make long-term loans (regularly amortized) as well as short-term, since it is in the long-term field that lie the important needs of South American countries. The bank's assets should be endorsed by central banks or governments. Its assets should be guaranteed by the governments concerned against exchange blockage. Probably its business should be conducted in United States dollars only. It should be free to accept deposits from any source and to issue its own debentures.

Such a bank would be free of exchange risks, so far as the law can make it free; within each country it would have the strongest security possible; and its field of operations would probably be adequate to enable it to pay its way. There are a number of ways in which it might improve the existing financial situation in some degree.

Possible constructive operations of the bank

1. Provision of better clearing facilities for exchange transactions among Latin American countries (probably not much scope for this).
2. Making short-term loans to meet seasonal and other temporary pressures on the exchanges (the Federal Reserve banks have made loans on gold for this purpose, but beyond this limited type of loan they have not gone).
3. Drawing to itself, by reason of its preferred international status, Latin American deposits that otherwise would be made in New York to escape domestic currency uncertainties; and reinvesting the funds in the country from which they were drawn (Latin American balances in New York have grown from about \$100,000,000 in 1933 to over \$300,000,000 today; in 1929 they were about \$200,000,000).

4. Making long-term loans which the private investment market is unwilling to make because of currency uncertainties, but which the bank could make because of its guarantee against exchange blockage. (The Export-Import Bank is making loans of this type today; but an Inter-American bank loan would throw less onus on the United States if eventually the debtor government has difficulty in paying.)
5. Sale of its own debentures in Latin American countries to supply outlets other than land or foreign securities for Latin American investment funds -- these funds to be reinvested largely in the countries that supply them.
6. The bank's operations would force it to appraise the financial status and programs of various countries and offer it opportunities to make suggestions. Advice from the bank or insistence on sound financial practices would represent the collective judgment of a group of American countries and not just the self-interest of a single creditor - the United States. It would tend to soften the charge of financial imperialism.

Perhaps the chief economic virtue of the bank would be the opportunity it would afford in the ordinary course of business to subject the records and financial programs of Latin American countries to the judgment of their peers, among whom would be a United States representative of presumably outstanding ability and reputation giving all his time to the job. Such a bank, operating on a small capital -- say \$50,000,000 -- with the United States supplying perhaps a quarter or a third of the capital and enjoying a veto power over major lending and borrowing activities of the bank, which could be made subject to a four-fifths vote, might be able to avoid loans to the most unstable or unreliable Latin American governments and develop a minor field of relatively safe action. While much of the bank's initial activity might be at the expense of business that in its absence would go to others, it might increasingly help to develop the exporting powers of Latin American countries through enlarging their system of roads and meeting other fundamental needs of an operating economy. The difficulty of finding export markets, however, that can be made directly or indirectly to yield dollars, will militate against extensive gains from such investments of United States funds.

If the bank can do at least a minor constructive job from the standpoint of its business operations and a somewhat more significant job from the standpoint of its influence on financial programs, we are informed it will serve a highly useful purpose in our broader Latin American policy. The world situation is shifting rapidly under the impact of war developments. Organization of an effective group of neutrals in this hemisphere is difficult because Latin American countries have so many economic and cultural ties with Europe and their internal situations are far from stable. The establishment of an institution that will bring these countries together with the United States in the solution of common economic problems will, therefore, be most welcome to the State Department. The Department is interested in developing all the cooperative machinery it can against the day when peace or major shifts in the course of the European war suddenly face the Americas with new emergencies. There is doubt whether the bank idea will meet with enthusiasm in every Latin American country, but interest in it is sufficiently active and widespread to make the idea worth developing from this broader political standpoint.

Pros and cons of Federal Reserve participation

If we are to have a bank, there is a question whether the Treasury or the Federal Reserve should represent the United States.

The argument for the Treasury is as follows:

1. The bank has a political significance. The Treasury is the financial arm of the administration. If losses are to be risked for the sake of political insurance presumably they should come out of the general revenues of the Government.
2. Ultimately the greater part of the bank's business will probably be in intermediate or long-term loans similar to those made by the Export-Import Bank, R. F. C., and other Treasury banking organizations.

For the Federal Reserve System the argument is:

1. The Federal Reserve is (or should be) the representative of the Government in the field of bank operations. It is equipped to do a banking business -- even in the field of longer term credits for capital purposes.

2. Latin American countries have emphasized their conception of the bank as a central bankers' institution, calling attention to the shifting political personnel of their Treasuries and their lack of a well-developed banking knowledge and philosophy.

These arguments do not point definitively to the Federal Reserve. The last point above might, indeed, be met (in a somewhat awkward way) by arranging for the Treasury to represent the United States and central banks to represent Latin American countries. The fact remains, however, that the Federal Reserve is the Government agency whose special field is banking; and unless it is prepared to pass more and more of its field over to others and play a diminishing rôle itself, it appears to us that it should seek to participate in the bank.

It is possible that the legislation that will be necessary to establish the bank could provide for a subscription to capital out of general revenues of the Government and representation on the board of directors of the bank through the Board of Governors of the Federal Reserve System. The case for the Federal Reserve will be stronger, however, if it is prepared to risk some of its own money. The amount involved would be small if only original capital is considered.

A feeling of moral responsibility for depositors and debenture holders might, however, lead to putting up more capital should the bank get into difficulties. Probably some understanding should be reached in advance that if a situation develops in which the United States appears morally obligated to put additional money into the bank the Federal Reserve will turn to Congress for the funds.