CONFIDENTIAL

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

OFFICE CORRESPONDENCE

February 15, 1944

To Governor Szymczak

From Walter R. Gardner

Subject: The International Investment Bank proposed by the Treasury

The Treasury has informed the Russian delegation which is now here discussing the International Fund proposal that, after discussions on the Fund have been completed, it would like to discuss the proposed Investment Bank. Copies of the Investment Bank proposal were sent to the finance ministers of the United and Associated Nations last November with the request that it be studied by their technical experts. No discussions of the proposal, however, have yet been held with any foreign experts other than Keynes and his group, when they were here last October. Keynes had some serious criticisms of the plan on first reading, and promised to send us a statement of his ideas on international investment after his return to England. He has not done so; and since the one meeting at which the Bank was discussed ended quite inconclusively, we do not know precisely where the British stand. They appeared, however, in the brief discussion that was held, to be strongly sympathetic to an international investment agency with active resources contributed almost entirely by the creditor countries, with freedom to finance purchases in the cheapest market, and readiness to follow a bold lending policy without too much insistence on a regular schedule of repayments. Since the October meeting with the British the Americans have done little on the Bank proposal; but the fact that it is to be discussed with the Russians indicates that very shortly the Federal Reserve technicians will be getting further committed on the whole arrangement and should, if possible, have some guidance from the Board beforehand. In fact the Board may presently be faced with the necessity of taking a definite position on the Bank; for Harry White talks as if he intended to offer both the Fund and the Bank proposals to Congress at the same time. While it is possible that the Bank will be dropped if time seems short or the political situation is unpropitious, the chances right now are that it will be brought along quickly as a companion piece to the Fund. If this occurs, the Board may be called on soon for a policy decision.

Two types of international action

It will help to clarify the Treasury proposal if we first consider separately the two approaches to the investment problem that are mixed together in the Treasury draft. One of these approaches is already embodied in UNRRA (United Nations Relief and Rehabilitation Administration) and has considerable support in the State Department. It might be called the "national agencies" approach. UNRRA is, of course, an international agency and members are subscribing funds for international relief under its auspices. But the funds subscribed by the United States are not given directly to UNRRA. They are appropriated to the President of the United States for use in the projects developed by UNRRA.* Con-

* It is understood that the President will employ the Foreign Economic Administration for this purpose.

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gress is more willing to vote the funds on this basis. As an added protection to the United States there are the Combined Boards on which Americans, British, and Canadians sit together. These Boards allocate the supplies under the control of the three countries as between various military, civilian, and relief needs. UNRRA will have to submit its supply needs to the Combined Boards for approval or modification. A further feature of the UNRRA set-up is that countries receiving relief from the organization will not be required to contribute any relief funds to it; yet they will have an equal vote in the management.* This vote can be given them because the funds and the supplies remain under the control of the national agencies of the chief contributing countries.

A quite different type of approach is embodied in the Treasury's Stabilization Fund proposal, or, as it is now called, the International Monetary Fund. It is contemplated that contributions will be made directly to the Fund, which will thus acquire a pool of resources directly under its command. This and other powers given to the Fund make it impossible to grant equal votes to all members as in the case of the UNRRA. The largest contributors are given the largest votes; but even so the United States will have only a 20 per cent voice in the management, and its controls will be much weaker than under the UNRRA arrangement. The Fund proposal, if it reaches Congress, will be the first great test of that body's willingness to appropriate American resources directly to an international organization on which this country has only a minority vote.

International investment organized on the UNRRA model

An international investment arrangement largely on the UNRRA model and embodying ideas now under consideration at the State Department might be as follows. There would be created an international investment agency. It would receive requests for loans and would itself develop investment projects involving at times possibly an entire region rather than a single country. It would determine the amounts that member countries in position to lend might properly invest in each project and so inform them. Meanwhile the legislatures of member countries would have appropriated funds for investment solely in the projects of the international agency. The agency for handling the appropriation in the United States would probably be the Export-Import Bank (now under F.E.A.). It would not be compelled to make the appropriated funds available to the international agency on any project which appeared to be unsound or against the interests of the United States; but it would be under strong inducement to give sympathetic consideration to every project of the international agency because failure to cooperate would condemn to idleness the funds that Congress had appropriated solely for investment in such projects. Inaction would clearly be a frustration of the will of Congress.

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* More exactly the arrangement is that occupied countries will be exempt from the contribution for relief purposes of 1 per cent of their national income; but they will be expected to make a minor payment toward meeting administrative expenses of UNRRA and to contribute from time to time in other ways if they find themselves in position to do so. **Countries with adequate gold and foreign exchange holdings will be expected to pay for their own relief independently of UNRRA.**

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Under this arrangement only countries in position to lend would be called upon to make international loans, although borrowers might have to supply funds for their local expenditures. Each lender would get the full interest return on his investment; and it could be urged that that alone was a sufficient material return to this country. We would be finding investment outlets for our surplus funds and getting a reasonable investment return on them. All the intangible and indirect benefits from a cooperative world enterprise of this sort would be so much velvet.

Voting arrangements in such a body could be extremely liberal because of the power the Export-Import Bank would possess to deny American funds to any particular project -- a privilege that each country would have with regard to its own investments. Members could be given equal votes as in UNRRA, and there could similarly be a small executive committee composed of representatives of the leading countries to act in place of the general body of members subject to periodic review of their actions by the membership as a whole.

While the entire arrangement would leave the United States as the predominant creditor nation and therefore the predominant influence, it would mark a considerable departure from straight Export-Import Bank loans. It would internationalize the process by bringing other creditor nations into the financing along with us; and prospective borrowers would find themselves negotiating with an international body which would weigh their projects against those of others from the standpoint of the membership as a whole. This is the procedure to which UNRRA will subject the requests of various countries for relief, and an international investment institution such as that discussed in this section would represent the same advance over the Export-Import Bank that it is hoped UNRRA will represent over the attempts of the United States to meet the relief situation single-handed and by direct deals after the last war. The State Department appears to be thinking somewhat along these lines in the belief that Congress might find such an arrangement acceptable and that there is danger in putting up to Congress a proposal that might be violently attacked and bring the whole movement toward reviving international investments through Government action into disfavor.

Treasury proposal

If Congress, however, is ready to appropriate as large an amount to an international as to a national agency, an institution such as the Treasury proposes would have much to be said for it. It could act more quickly and with greater freedom. This would be abundantly evident if the Treasury were proposing a full-fledged international institution instead of one which mixes the UNRRA and the Monetary Fund approach. A straight international agency commanding its own resources could be a highly effective instrument for transferring capital from countries in position to play the role of creditor to countries with undeveloped resources. It would be free of nationalistic restrictions which might otherwise compel it to tie its loans to exports from the lending country. Lending countries could get their appropriate reward in the form of a return on the funds lent. They would be stockholders in an international corporation in the management of which borrowers would have some voice even though they held

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no stock. Loans of the agency would be truly international and available for expenditure in whatever country could best supply the goods needed for the investment project. Such an agency would not serve the political ambitions of any country. It could not be accused of dollar diplomacy. While the UNRRA approach would mark a significant step in this direction, a full-fledged international agency would mark a still greater step.

As it is, however, the Treasury proposal falls short of a full-fledged international agency. It is a curious, and perhaps politically adroit, mixture of the UNRRA and Monetary Fund approaches. Some of the mixed aspects of the Treasury proposal are discussed below.

Source of Bank's funds: gold in particular

The Bank does not draw its resources from creditor countries alone. Borrowers are compelled to contribute. This is appropriate if the borrowers' contributions are to be lent back to them for use within their own borders to cover the domestic financing involved in a developmental project. It is less defensible, however, if it means that the funds of one borrowing country are to be lent to another. A borrowing country can become an international lender only by borrowing abroad what it lends. The wisdom of forcing it to do so may be questioned. Yet this is what the Treasury proposal contemplates. It establishes a strong presumption against lending back to a country the resources it has contributed to the Bank. The implication is that the resources are to be lent abroad.

It is true that every member has the right to veto the Bank's use of the member's currency, and this power could be used by a borrowing country to prevent its currency being lent abroad. While it could thus condemn the currency portion of its contribution to idleness, it could not prevent the gold portion from being used as the Bank saw fit. Up to 20 per cent of the contribution must be in gold and the original contribution will subsequently be increased by the requirement that countries convert 2 per cent of their currency subscription into gold each year (except as this takes more than half the gold they acquired during the preceding year). The Bank may also require servicing of its loans in gold. It is the hope of the Treasury that ultimately the Bank's assets will be entirely on a gold basis and free for use anywhere in the world at the Bank's discretion.

In addition to the problem of forcing borrowers to become lenders, these Treasury gold provisions raise another question. Is gold an appropriate instrument for long-term financing? Prima facie, the answer must be "no". The Bank should not finance its investments by shipping gold to the United States on a permanent basis. Any gold that foreigners can be persuaded to contribute to international institutions should be contributed to the Monetary Fund. In doing so they would not weaken their reserve position because the Fund would give them presumptive rights to draw upon it for foreign exchange equivalent in amount to their gold contribution; but they would be permitted to draw only if they were taking effective measures to correct their unbalanced international position. Hence the gold contributed to the Fund would tend to stay there. It would be used only to meet temporary situations, which is the proper use for gold. The International Bank on the other hand, employing it for

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long-term investments, might shift it permanently to the United States, leaving foreign reserves weakened and this country burdened with additional billions of dead assets, the acquisition of which by the Federal Reserve Banks would strengthen inflationary forces.

The prima facie case then is strong for eliminating gold contributions from the Bank and increasing them to the Fund. The decisions on the Fund, however, have already been taken. Foreign gold and dollar contributions will be limited to about 1 billion dollars out of the 15 billion dollars owned abroad. While some of the 14 billion dollars left in foreign hands will be diverted to the Fund by provisions that come into play after the Fund starts operations, the chances appear to be that a very large proportion will be available to finance foreign deficits with the United States incurred by countries which are not taking adequate measures to correct their unbalanced positions. The Fund will have no power to prevent such developments. Member countries using their independent reserves have no obligations under the Fund arrangement to stop a capital outflow or a chronic trade deficit.

Under these circumstances the argument for keeping foreign gold out of the Bank becomes less cogent. If foreigners are prepared to contribute to the Bank gold that they are unwilling to contribute to the Fund, the problem of the independent foreign gold reserves is to that extent reduced. The justification is much the same as in the case of UNRRA, which requires countries with adequate gold holdings to use them to pay for relief. Relief represents even more permanent financing than does long-term investment; but if the United States is likely to get much of the foreign gold anyway, it had better get it in connection with well-conceived relief and investment projects rather than as the counterpart of capital flight or of the overflow of miscellaneous expenditures resulting from an outpouring of domestic funds abroad.

Furthermore, it can be said in behalf of the Treasury proposal that it deals gently with prospective gold contributors. Only to a minor extent will countries inadequately supplied with gold be forced to assume the role of lenders. The original gold contribution will be pared down below 20 per cent of the whole subscription for countries poor in gold. Subsequent gold contributions (equal to 2 per cent annually of the currency subscription) will be required only from countries that are gaining gold, and even this requirement may be waived by a 3/4 vote of the Board. The Treasury can argue with some force that, whatever the logical defects of a gold contribution by borrowers, the amounts involved are immaterial except in those cases in which the country can readily spare the gold.

The Treasury can then go on, as it does, to emphasize the importance of having something more than foreign currencies contributed if the plan is to prove acceptable to Congress. Congress is likely to welcome the statement that all members are contributing according to their size -- contributing not merely their own somewhat doubtful currencies, but gold itself. Will Clayton, a shrewd judge of Congressional reactions, supports the Treasury in this view.

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Aside from the gold contribution which is illogical, but perhaps expedient, there are few peculiarities in the sources of the Bank's funds. The Bank will be permitted to stretch its capital by selling its own securities if the representative of the member country concerned grants his approval. It may also guarantee loans made by private interests to the government of any member country or to business enterprises on the guarantee of such government. There are no limits to the amount of securities the Bank may issue or guarantee. Undoubtedly definite limits should be imposed. Without them the Bank may incur obligations greater than it can meet and be forced to call upon members for contributions in excess of their original commitment.

Member veto over use of Bank's funds: tied loans

The feature in which the Bank departs most widely from a full-fledged international institution is in its lack of freedom to utilize its resources where it will. Such freedom exists only in the case of gold holdings of the Bank. Before it can use its currency holdings the Bank must obtain the approval of the countries to which they pertain. It is possible that even gold may to some extent come under this limitation since, to be spent, it must first be converted into currency, the use of which would presumably require the approval of the country concerned. But gold is at least free to be converted into any currency the Bank needs.* If the Bank runs short of sterling, its gold can be used without question to buy pounds. Its dollars, however, cannot be converted into pounds without the approval of the American representative.

This veto power over the use of a country's currency is a long step away from a full-fledged international agency. It bears a strong resemblance to the UNRRA type of organization. Ostensibly the Bank has large resources of its own; in fact most of them are controlled by the individual members. The Treasury defends the provision as necessary to make the Bank acceptable to Congress. Congress can be told that dollars will be lent by the Bank solely to finance American exports unless the American representative approves of some other use.

No stress need be laid at the outset on the fact that the case is not watertight. There are leaks. The 20 per cent in gold that we contribute is not subject to our control; and our gold contribution will rise year by year. Furthermore, any dollar loans repaid in gold or other currencies will thereafter escape the American veto power. As time passes the controls may pass out of our hands. The whole arrangement is an ingenious device for starting out on one basis and ending up on another. If freedom of the Bank is considered politically inadvisable at the outset, but economically desirable in the end, there is much to commend the Treasury formulation.

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* Gold can also be used directly to reimburse a supplying country for the raw materials it has to buy abroad in order to manufacture supplies purchased by the borrower, and gold can also be lent to the borrowing country to pay for imports indirectly resulting from the project.

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From an economic standpoint the question is largely one of which arrangement would lead to the most constructive use of the Bank's funds. There is danger that a Bank dominated by debtors and in full command of all its resources would be drawn into a series of wasteful loans. The danger may be substantially reduced if creditors' funds remain subject to their control, giving them an opportunity to study each investment project and reject those that appear to be poorly conceived. The drawback of this (the UNRRA) method is that creditors are more likely to adopt short-sighted policies of tying loans to exports of their own goods if they have the power to grant or withhold funds in each case.

It is possible that once again the Treasury has hit upon an illogical but expedient mixture of philosophies -- one that by tying down the Bank will have considerable appeal to Congress at the crucial stage of voting on the plan, but that thereafter step by step will give the Bank increasing freedom. As time passes it may be hoped that the Bank will gain experience, set up adequate standards of performance, and generally qualify itself to exercise the wider powers it obtains.

Returns to shareholders

UNRRA involves grants. Contributors must weigh the sacrifice involved against the general benefits obtained. The Bank is an investment institution. Creditor countries should welcome it as an outlet for their abundant capital. It should not be necessary to plead with them to make a contribution to the general welfare or even to their own export trade; it should be enough that they are finding a constructive investment on which they earn a fair return. Such a case can be made, however, only if creditors in fact get the earnings on their funds employed.

From this standpoint it is a defect of the Treasury proposal that borrowing countries will be forced to contribute funds that will never be used. Attention has already been drawn in an earlier section to the anomaly of trying to make lenders out of borrowing countries. The argument there had to do with their gold contributions. In this section it is their currency contributions which must be questioned. Either they will be used, in which case the borrowing country is forced to lend and all the objections in the earlier section to gold contribution will apply; or they will lie unused. Unused currencies add nothing to the earnings of the Bank; yet the borrowing countries will share in the Bank's earnings to the full extent of the idle currencies they have contributed. Returns to the creditor countries whose funds are employed will be arbitrarily diminished. Their investment will be impaired to that extent.

This situation could not arise under the UNRRA type of international investment organization described in an earlier section; and it would be comparatively easy to meet if the Treasury's Bank were set up so as to carry through in full the UNRRA type limitations that are a conspicuous feature of it at the outset. If all contributions were in currency and all loans were serviced in the currencies in which they were made, it would be easy to give each contributor a return commensurate with the actual use of his contribution. As things stand, however, it would be far too complex to trace what has happened to that portion

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of a country's contribution that is made in gold or is lent and repaid in gold or other currencies. The complexity will grow with the passage of time. Perhaps the best that can be done to minimize this defect of the Treasury plan will be to cut the subscriptions of borrowers to small amounts. The subscription formula which in the present draft must take account of the national income and the international trade of a member country might more appropriately be based instead on the member's international capital position, or at least give that factor dominant weight.

Equity investments vs. fixed loans

A basic difficulty of Government lending is that almost inevitably it must be carried out through fixed loans rather than equity investments. Bond contracts proved quite unadaptable to the world depression in the 1930's. They helped to provoke crisis after crisis with their schedule of fixed interest and amortization payments in the face of shrinking export revenues for the borrowing countries. Out of such crises came a mass of defaults; and once bond contracts were broken there was little chance of ever getting back again to the original basis. Service of the loan was stopped or permanently reduced.

Equities, on the other hand, showed a high degree of adaptability. The return on American investments in subsidiaries abroad declined as foreign income declined and consequently the transfer of earnings back to the United States put less pressure on the exchanges. When subsequently there was recovery abroad, equity earnings rebounded. In the end they proved more profitable than bonds to the investor, but they were gentler on the borrowing country in the critical period.

In addition to these advantages, American investments in subsidiaries abroad had another virtue. They often carried with them the technical skills necessary to organize a project and get it operating successfully. Export of "know-how" will be quite as important as export of capital in many of the undertakings of the post-war period.

Such investments, however, are hardly the sort that Governments can properly make abroad. For the American Government to own a growing number of enterprises in foreign countries would arouse fears of political domination -- particularly as the enterprises would be in basic industries such as power, transportation, communications. Even an inter-Governmental Bank would be suspect. The Treasury proposal goes no farther in this direction than to permit the Bank to invest in equity securities* an amount equivalent to 10 per cent of its paid-in capital.

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* It is possible to interpret the text of the proposal to mean that the Government of the borrowing country must guarantee the conversion into foreign exchange of the current earnings of such securities. How much assurance this would give, in view of the experience of the dollar bonds of foreign Governments, is problematical.

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It does, however, introduce into fixed loans some of the adaptability of equity investments by permitting the Bank in event of an acute exchange stringency to accept local currency in payment of interest and principal for periods not exceeding three years. And there appears to be no reason why the Bank should not also arrange to supply skilled technical leadership in the enterprises it finances. The Export-Import Bank has often done so in connection with its Latin American loans, and a world Bank representing Governments and conceiving of its investments in terms of broad economic development should have both the incentive and the means for procuring the necessary technical men to do the job. In this way some of the major advantages of the equity investment could be embodied in the loans of the Bank.

How bold a lending policy?

Even if the Bank were free to invest all its resources in equities, the question of how bold an investment policy it should pursue would not be settled. Equity investments would permit enterprises to pay the Bank by giving it an adequate return over the long run instead of according to a regular semi-annual schedule; but the more basic question is whether the Bank should seek a return at all. Keynes, when he was here, suggested that the Bank should "cast its bread upon the waters" looking to the general benefit and not figuring too closely on the scheduled returns to itself. Alvin Hansen is, I believe, prepared to express himself even more explicitly and to make a reasoned defense of the proposition that the benefits to American employment, the cheapening of our imports, and the opportunities for private investment that might result from an intelligent development of raw material countries might justify American Government loans even though no interest were received and a substantial part of the principal were lost. It is argued that, if the Bank confines itself to investments that bid fair to pay a return, it will do no business; for private investors will preempt the field. Therefore it must go into lines that on the whole will leave it with losses.

This conclusion, however, does not necessarily follow. The Export-Import Bank has managed to do a paying business. The difficulty is not that there are no productive loans to make; but that private investors are so afraid of the international situation that they will not make them. Governments have ridden roughshod over them. This is less likely to happen to an inter-Governmental Bank created to assist Governments. Furthermore the Bank will be working closely with the Fund. Both agencies will be watching the entire economy of a borrowing country and its international balance of payments. Both will be in position to influence its policy. Together they can deal far more effectively with the movements of trade and capital that underlie successful investment than can any individual or group of private investors. The risks to these world institutions will therefore be less. Business that is unsafe for the private investor will be safe for them. There will certainly be a field beyond the range of private investment in which the Bank can do business and obtain an adequate return.

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But should this field be extended by adopting the principle that the Bank should make loans on which it believes that it will get only a portion of its principal back? Those who urge such a policy make it clear that they are not advocating blind waste. They would require the Bank to put the funds to constructive use even though the test of that use would not be the direct return obtained. They would be satisfied with the flow of indirect benefits.

Properly considered, however, their argument would seem to be one for extending the scope of UNRRA or carrying over some sort of Lend-Lease arrangement into the years of peace. The grants to UNRRA are expected to pay for themselves in indirect benefits. There is a sound case for them. But most of the benefits go to the countries immediately concerned rather than to the contributors; and when these countries get sufficiently on their feet to engage in productive business, it appears reasonable for them thereafter to pay for the loans they obtain. Such a requirement is the strongest insurance against waste.

From the standpoint of its own welfare the United States might properly hesitate to go on subsidizing foreign governments after the UNRRA job is done. It could get all the stimulative effects of public expenditure on employment and retain the direct benefits of the expenditure for its own people by taking steps to deal with depressed areas and groups within the United States. Roads, housing, schools, medical care, and various forms of insurance -- in these and many other directions there is almost limitless room for public expenditure on our own people whenever such expenditures are needed in the interests of a full productive economy. Humanitarian considerations may lead us to continue to give resources to foreign countries, but our action along these lines should find its outlets through UNRRA and not tangle up the operations of the Bank. The Bank should be permitted to establish itself as a genuine investment institution earning a return on the funds entrusted to it.

Such a Bank would go far toward preventing creditors from taking the position that their subscriptions must be used only to boost their own merchandise exports or to yield political advantages of one sort or another; for the subscriptions would be investments, not gifts. And the demoralization of borrowing countries that follows the discovery that all are not treated alike, that one is expected to pay and another not, would be avoided. Every borrower would have to satisfy the Bank that his project was sufficiently productive and its management sufficiently well selected to enable the borrower to repay the Bank. Effects on national income, fiscal revenues, and international balance of payments of the borrower would all be considered and have to pass the test. And the loans that passed the test would not only promise more direct return than those that failed, but in most cases far greater and more permanent indirect returns as well.

Possible action by Board of Governors

This somewhat extended discussion of the Treasury plan points to few sharp conclusions. The Treasury plan is a mixture of philosophies with plenty of technical complications; but most of these complications

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represent attempts to meet various illogicalities of political attitudes, both here and abroad. They cannot be rejected out of hand. They must be weighed in the light of conflicting considerations. Probably the Board will not want to concern itself very much with these technicalities, nor take positions with regard to them.

What would be helpful to the staff, however, would be an expression of the Board's viewpoint on the basic approach. Should the aim be to create an investment agency on the UNRRA model with control by each member over his own contribution, or should the aim be to create a full-fledged international institution with resources completely at the disposition of the managing board, on which the United States would have only a minority vote? The Treasury proposal can be modified in either direction.

It would also be helpful to the staff at this time to have definite confirmation of its understanding that the Board is strongly in favor of reviving the flow of international investment by whatever means are most effective. We have repeatedly taken the position on the Monetary Fund that other international measures were necessary for its proper operation and were in fact of even greater importance than the Fund in the effort to build a going world. One of the chief measures of this character is an agency for the revival of international investment. We have understood that our position was in accordance with the Board's viewpoint; but now that we are working on a specific proposal to meet the international investment problem it would be well to have renewed confirmation of that understanding.

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