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Relationship of Federal Reserve System
to Bretton Woods Institutions

The International Monetary Fund and the International Bank for Reconstruction and Development have been launched with the full support of the United States Government, and this country has a very considerable interest in their success. It is therefore incumbent upon the Federal Reserve System to do everything it reasonably can to cooperate with and facilitate the operations of these institutions.

Section 6 of the Bretton Woods Agreements Act provides that: "Any Federal Reserve bank which is requested to do so by the Fund or the Bank shall act as its depository or as its fiscal agent, and the Board of Governors of the Federal Reserve System shall supervise and direct the carrying out of these functions by the Federal Reserve banks." However, in addition to these functions prescribed by law, the System authorities should consider what other action they might properly take to support the Fund and Bank. These institutions are still in the formative stage but it would be desirable to make preparations now for providing such additional services to these institutions as may be considered appropriate.

The following recommendations are submitted concerning System action on matters other than the routine depository functions which will be provided pursuant to the Bretton Woods Agreements Act.

1. Loans to the Fund or Bank on Gold or
United States Government Obligations

Recommendation. The Federal Reserve Banks should be prepared to make loans to the Fund or Bank on gold or negotiable United States Government obligations. However, before any such loan is actually made, the Board of Governors, after consultation with the National Advisory Council, should approach the Banking and Currency Committees to make sure that in their view the Congress did not intend to require specific Congressional consent for such loans under the terms of the Bretton Woods Agreements Act.

Discussion. Such loans are clearly within the powers of the Reserve Banks as defined in the Federal Reserve Act, but Section 5(e) of the Bretton Woods Agreements Act prohibits loans to the Fund and Bank "on behalf of the United States" without specific Congressional authorization. It is clear that, legally, loans by the Reserve Banks to the Fund and Bank would not be loans "on behalf of the United States", even though a loan of this character would seem to require specific approval of the Board of Governors. It was presumably not the intention of Congress, therefore, to prohibit loans by the Reserve Banks to the Fund or Bank. Even if it had been, it is not

certain that Congress intended to prohibit any loans to the Fund or Bank which, as in the case under consideration, would not add to the total amount of dollars committed to the Fund or Bank by the United States.

Clarification of this matter would be desirable even though the subject is not of great practical importance. The Fund may never hold any significant amount of negotiable United States Government securities and it will have no occasion to borrow on gold until its initial supply of dollars runs low. The Bank may hold small quantities of gold and larger quantities of U. S. Government securities, but the likelihood of its desiring to borrow against these is remote.

2. Loans to the Fund or Bank on Other Types of Collateral or Without Specific Security

Recommendation. No authority should be sought at this time to make loans to the Fund or Bank on collateral other than gold or United States Government obligations, or without specific security.

Discussion. As stated above, it is most unlikely that the Fund will hold any significant amount of U. S. Government obligations. It is even more unlikely that it will have suitable collateral other than gold or United States Government obligations. It would need an unsecured loan only if its gold and dollar holdings were running out, i.e. if dollars were becoming scarce in the Fund. The question of whether the United States would desire in such circumstances to replenish the dollar resources of the Fund, and if so what role the Federal Reserve Banks might play in the process, is a matter for future determination.

There is little reason to believe that the Bank will wish to borrow on collateral other than gold or United States Government obligations. The Bank will normally borrow by issuing its own debentures. It will also normally hold U. S. Government securities against which it could borrow in the unlikely event that overnight or short period accommodation were needed.

3. Direct Transactions in Negotiable United States Government Obligations with the Fund or Bank

Recommendation. The Federal Reserve Banks should be prepared to trade directly with the Fund and Bank in negotiable United States Government securities, and appropriate action should be taken by the Federal Open Market Committee.

Discussion. The Fund is most unlikely to have U. S. Government securities for sale. It cannot purchase such securities and would otherwise acquire them only in case they were put up as collateral for special assistance by the Fund to a particular member and subsequently forfeited. The Bank can buy and sell them in the process of investing its special reserve, although its holdings will not be large, at least for some time.

The Reserve Banks could carry out these transactions by operations in the market as fiscal agent for the Fund or Bank. However, in view of the special character of these international institutions, it is believed appropriate for the Reserve Banks to deal with them directly in negotiable United States Government securities. Under existing practices, no formal action would be required to authorize such dealing in Treasury bills, but direct transactions in longer-term issues would require authorization by the Federal Open Market Committee.

4. Direct Transactions in Bankers' Acceptances and Eligible Bills of Exchange with the Fund or Bank

Recommendation. No action is necessary since it is most unlikely that either the Fund or the Bank will hold any significant amounts of such paper, and if they do they can avail themselves of open market facilities.

5. Purchases from or Sales to the Bank of Cable Transfers

Recommendation. No action is necessary.

Discussion. The Bank may have occasion to purchase (or sell) cable transfers but such transactions would normally be discharged by the Reserve Banks as fiscal agent. The only case in which there would be occasion for the Reserve Banks to act as principal would be if the transaction coincided with desire by the Reserve Banks to increase (or decrease) their deposits in foreign countries. In such case the operation could be carried out pursuant to the existing ruling of the Federal Open Market Committee providing for purchases and sales of cable transfers by the Reserve Banks in connection with the operation of their foreign accounts.

6. Participation in the Distribution of Bank Debentures

Recommendation. The Reserve Banks should not act as members of or assume responsibility for organizing any underwriting, sponsoring, or distributing group which the Bank may desire to set up in offering its debentures to the public. However, the Bank may decide to dispense with such a group and arrange for a direct offering of its debentures possibly with provision for commission to dealers. In such case the Reserve Banks as fiscal agents for the Bank should be prepared to receive subscriptions, subject to allotment, from banks, dealers, and the general public.

Discussion. It is not considered desirable for the prestige of the Federal Reserve Banks to be involved in public appeals for subscriptions to Bank debentures. Such appeals should be made either by an underwriting or sponsoring group in the market, or by the Bank itself. However, there is no reason why the Reserve Banks should not receive subscriptions

on behalf of the Bank in their capacity as fiscal agents for the Bank, it being understood that they would not lend their names to prospectuses issued in connection with the Bank's offerings.

7. Market Stabilization Operations, by the Reserve Banks as Fiscal Agents, in Securities Issued or Guaranteed by the Bank

Recommendation. Upon request by the Bank, the Reserve Banks should be prepared to engage in market stabilization operations in securities issued or guaranteed by the Bank, acting as fiscal agent of and for the account of the Bank.

Discussion. Market stabilization operations for the account of the Bank, which would constitute an appropriate activity of the Reserve Banks in discharging their duties as fiscal agents, are to be distinguished from operations by the Reserve Banks for their own account (see next section). If it is not deemed desirable to undertake transactions of the latter type, care should be taken in the case of operations for the account of the Bank to let the market know that the Reserve Banks are intervening only as fiscal agents and not as principals.

8. Market Stabilization Operations, by the Reserve Banks for their own Account, in Securities Issued or Guaranteed by the Bank

No recommendation is made on the subject, which involves some very fundamental issues of System policy. In an attempt to clarify these issues, however, the attached statement (Appendix I) has been prepared outlining a possible form of System action in this field and discussing its implications.

Proposal for Market Operations, by the Reserve
Banks for their own Account, in Securities
Issued or Guaranteed by the Bank.

Proposal. It has been suggested that the Federal Reserve System seek an amendment to Section 14(b) of the Federal Reserve Act authorizing the Reserve Banks to purchase for their own account in the open market securities issued or guaranteed by the International Bank for Reconstruction and Development, up to an aggregate holding of 500 million dollars at any one time, for the purpose of aiding the market for these securities. This authority would be used at the discretion of the Federal Open Market Committee to conduct market operations in such securities. These operations would be aimed at maintaining an orderly market in these securities, in the sense that the System maintained an orderly market in U. S. Government securities in August and September 1939, and, in thin markets, at providing bids and offerings, on a graduated scale, in moderate amounts. Pegging operations are not contemplated and it is not the purpose to maintain a fixed level of yields except in order to give the market an opportunity to adjust itself to sudden unforeseen developments.

If Section 14(b) of the Federal Reserve Act is amended as proposed, consideration might also be given to seeking an amendment to Section 13 of the Federal Reserve Act making securities issued or guaranteed by the International Bank eligible as collateral for advances to member banks under that section.

If the System should seek and receive the authorization suggested, there would be the further question as to how the securities should be shown in the Reserve Banks' weekly statements. If more than nominal amounts of such securities were purchased, it is believed that they should be shown in such statements as securities of the Bank; if only nominal amounts of such securities were purchased, they might be shown in "Other Securities".

Discussion. (a) Service to be performed. As stated in the proposal, pegging the price of the Bank's securities or quasi-permanent support is not contemplated. Any attempt to stabilize prices of the Bank's obligations at fixed levels might ultimately prove impracticable in view of the nature of the Bank's resources and the strains to which it will be subjected by developments in international economic and political affairs. On the other hand, operations along the line of the above proposal would assure the Bank's securities some protection (though not complete insulation) from temporary market disturbances and facilitate the development of a broad market in such securities. The test of success in these operations would be the extent to which, over a period of time, the range of current market

fluctuations in the Bank's securities could be reduced without any large net accumulation of such securities in the System's open market portfolio.

It is of great importance to the United States that the International Bank project succeed, and therefore that the security-selling job be successfully carried out. If the Bank is to meet in timely fashion the very heavy and urgent demands for funds which will be made upon it, it must sell large amounts of its securities before they have become thoroughly seasoned. A strongly-backed stabilizing force in the market would undoubtedly assist the Bank in floating its securities by making the securities more acceptable to conservative investors, especially institutions, to whom most of these securities will probably be sold. This kind of aid to the marketability of a security is particularly useful when the total amount of the issue or issues, as in this case, is very large and is to be marketed over a relatively short period (e.g., several billion dollars within a few years). The period during which the function of the proposed market operations might be of greatest importance is the first year or two after the securities come on the market. Even if no active operations should be necessary during this period, it is then that the knowledge of potential Federal Reserve operations in the background would probably be of maximum constructiveness.

(b) Alternative to Federal Reserve action. The function of market operations in the Bank's securities, if not performed by the Reserve Banks for their own account, could be performed by the International Bank itself, perhaps using the Reserve Banks as fiscal agents. However, this course would be disadvantageous from the point of view of the Bank if in order to hold funds in reserve for market operations the Bank had to curtail its lending program. The likelihood of such a condition developing is difficult to judge. The situation would clearly arise if the Bank could not borrow funds faster than needed to meet disbursements on the loans it desired to undertake. It would also arise if the Bank could not borrow faster than needed to cover its commitments on loans and felt bound to hold funds available at all times to cover its outstanding commitments. However, the Bank might decide to use for market operations funds which had been committed but not yet disbursed. Furthermore, operations by the International Bank in its own securities, although not contrary to recognized practice, would certainly not inspire the same confidence in market circles as operations by the Federal Reserve System.

(c) Implications for System policy. The case for System operations in the Bank's securities rests upon the argument that acceptance of this responsibility would constitute an important service in the national interest and would increase the System's stature and influence in the international financial field. On the other hand, such operations represent a departure from previous System policy and involve certain risks, including that of pressure upon the System to accord similar treatment to other securities.

Market operations by the System in the Bank's securities would strengthen the System's position in the international financial field already recognized in the statutory membership of the Chairman of the Board of Governors on the National Advisory Council. To the extent that the Federal Reserve System thus broadens the scope of its operations its views would command more attention. In the field of fiscal policy a similar effect has followed from the System's operations in Government securities.

There is no necessary conflict between the proposed operations and the System's general domestic monetary policy. The operations would be carried out within the framework of general policy and would serve to add to the markets with which the System maintains direct contact. The System might be under pressure at times to put money into the market in support of the Bank's securities when general monetary policy called for absorption of funds. But usually this situation could be met by relatively small offsetting operations in short-term Governments. If any real conflict arose, of course, System policy would have to be governed by the overriding criterion of domestic monetary requirements, a reservation which would have to be made clear in advance to the International Bank.

The fact remains that the System would be going considerably outside the field in which it has hitherto operated; and any undertaking by the System to operate in an area where prices are influenced not only by fluctuations in interest rates but also by credit risk, requires careful examination. While the present proposal relates only to the securities of this one issuer, it is possible that such an authorization might lead to pressure for similar authorizations with respect to securities of various government instrumentalities. A case might be made, however, for the special character of this issuer, the unfamiliarity of the American public with its securities, the greater range of market uncertainties with respect to international securities, and the great volume of long maturities that will have to be placed in a relatively short period of time. When and if the Government desires to lend further assistance to institutions like the Federal Land Banks, Federal Intermediate Credit Banks, Federal Home Loan Banks, etc., this might better be accomplished by the Treasury obtaining the authority to finance such corporations directly.

A further risk of the proposal is that, once the Reserve System has been authorized to support the market for the Bank's securities, it might find itself under political pressure to do so at times against its own judgment. Indeed, operations of the kind proposed might be interpreted as indicating Federal Reserve sponsorship. If conditions developed in which some declines had to be accepted, the System might be faced with complaints from investors who suffered losses as a result of their unwarranted reliance on the System's support.

Finally, the possibility cannot be excluded that the System might suffer losses on its holdings of Bank securities. It can be demonstrated,

however, that no loss can occur in final liquidation of the Bank unless more than 60 per cent of the foreign obligations to the Bank (borrowings and uncalled subscriptions) are defaulted. And even on the extreme assumption of a 100 per cent default by foreign countries, the Reserve Banks' loss on the maximum holdings of 500 million dollars in Bank securities would not exceed their present surplus (358 million dollars). In addition to the possibility of some eventual loss, the possible immobilization of some part of the System's assets over a long period of time should be recognized and weighed against the objectives sought by the proposal.

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The fundamental objective is not stability for its own sake, but the creation of a market which is broad enough to absorb the large amount of securities that the Bank must sell. The maintenance of an orderly market for the Bank's securities will contribute to this end. An even more powerful influence toward the same end might be the provision of incentives for distributors to conduct an aggressive selling campaign, such as a not too finely cut yield and an attractive selling commission.

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