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Inflationary Implications of International Bank Operations in U. S.

The activities of the International Bank in lending dollars abroad will undoubtedly have inflationary effects in this country during the next year. However, we must accept most of these effects if we are to give timely aid to foreign countries in their efforts to reconstruct and stabilize their economies. And we should be clear on how much of them are fairly attributable to the existence of the Bank, and how much would have manifested themselves if the aid had been financed in other ways.

The most direct and important inflationary effect of the Bank's operations will arise from the additional demand for exports which will be stimulated by its dollar loans to foreign countries. Although in general these dollars will be free for expenditure in any currency area,1/ it is certain, in view of the present world supply situation, that the bulk of them will be spent directly on U. S. exports of goods and services. Even to the extent that in the first instance they are spent elsewhere and become accretions to the dollar reserves of foreign countries, the same world supply situation is likely to result in their expenditure in this market within a relatively short period. In short, directly or by a somewhat delayed indirect process, any dollars lent by the Bank will enter our market in competition for domestic production of goods and services.

But the lending operations of the Bank can be fairly said to have had direct inflationary consequences in our markets only when they have stimulated additional exports, i.e. exports which foreign countries would not have bought in any case under alternative financing methods. In the absence of the Bank, some countries which will use its facilities would have floated their own dollar loans in our market (though at higher interest rates). Others would have drawn more heavily on their existing gold and dollar reserves. Badly needed goods would have been acquired, however great the immediate sacrifice. However, in the case of loans from the Bank which displace the liquidation of foreign gold and dollar reserves, while no immediate net inflationary effect ensues, it should be noted that the higher level of reserves remaining in foreign hands contains a possible inflationary threat for the future.

The Bank's operations may also have effects tending to increase inflationary potential in our domestic money market. A detailed statement is appended showing the effects on commercial bank deposits and reserves of various types of Bank operations. More concretely, a picture might be drawn of the development over the next year based on the following simplified assumptions:

1. The Bank makes direct dollar loan commitments of $2,000 million of which $1,200 million is disbursed to foreign borrowers. (No guarantee operations.)

1/ As an exception, the U.S. is authorized to require that loans made from 18 per cent out of its 20 per cent paid-in subscription to the Bank be utilized only for U.S. exports, but it is not expected to insist on such a condition.

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2. Foreign borrowers disburse the full $1,200 million, but $250 million is spent in third countries; these countries respend $200 million in the United States during the period, and are temporarily holding $50 million in their dollar reserves with the Federal Reserve Banks.

3. The Bank's loan commitments are fully covered by its paid-in dollar capital ($635 million from the 20 per cent paid-in U. S. subscription and about $90 million from the 2 per cent dollar subscriptions by foreign countries) and by debentures outstanding in this market of $1,275 million, of which $275 million has been taken by commercial banks.

4. Disbursements on the Bank's loans have been made out of its paid-in capital, and to the extent necessary ($475 million) out of the proceeds from debentures. The remaining $800 million of debenture money is invested in U. S. Government securities.

On these assumptions, the effects on commercial bank deposits and reserves over the year as a whole may be summarized as follows:

(a) Deposits will have increased by $315 million ($275 million of bank subscriptions to debentures, plus $90 million of foreign government subscriptions drawn from foreign accounts at the Federal Reserve Banks, less $50 million accumulated in accounts at the Federal Reserve Banks by foreign countries in which part of loan proceeds are spent).

(b) Required reserves will have increased by $160 million ($55 million to cover the increase in deposits and $105 million to cover the shift from war loan account to ordinary deposits of the dollars represented by the U. S. paid-in subscription).

(c) Reserves will have increased by $40 million ($90 million added to market from funds subscribed by foreign governments less $50 million withheld from market by foreign countries).

(d) The net reduction in excess reserves (or the need for additional reserves) would therefore have been $120 million.

It is important to point out, however, that this analysis proceeds on the assumption of "other things being equal"; in particular it assumes that the $635 million to be paid in on the U. S. subscription to the Bank would have remained in the Treasury's war loan account if not used for this purpose. In view of the Treasury's current debt redemption program, it may be more reasonable to assume that this money would have been used to retire bank-held debt, in which case an equivalent amount of deposits would have been extinguished. Allowing for this factor, the Bank's operations over the coming year may cause commercial bank deposits to be $950 million higher than they would otherwise have been. No amendment is necessary in the reserve calculations.

On the other hand, once the assumption of "other things being equal" is abandoned, attention should be directed to the inflow of foreign gold and dollar reserves which might have occurred over the next year in the absence of the Bank. If the $1,150 million of exports from the United States were purchased

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here in any case and financed through the liquidation of foreign countries' gold and dollar reserves, not only would there be an increase in commercial bank deposits greater than that attributed to the Bank's operations in the preceding paragraph, but commercial bank reserves would rise correspondingly. Actually the additional liquidation of foreign reserves which might occur in the absence of the Bank would not doubt be considerably smaller than this, but it would certainly be an important inflationary influence on our money market.

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In conclusion, it is repeated that the most important inflationary impact on our economy of the International Bank's operations arises from its financing of additional exports. The more rapidly the Bank raises and disburses funds, and the more the Bank directs its loans toward countries which without such assistance could not buy in this market, the more serious this impact will become. These are matters over which the National Advisory Council has control and the decisions of that body on the Bank's borrowing and lending operations will largely determine the extent to which inflationary consequences occur.

By comparison, the particular methods by which the Bank raises dollar funds in this market are unimportant. It is true that it would be preferable to have all of the Bank's debentures placed in the hands of "genuine" investors without participation by the commercial banking system. However, even to the extent that banks do buy them, the result would be far preferable to the inflow of foreign gold and dollar reserves which might occur in the absence of Bank financing.

Furthermore it should be borne in mind that any move to discourage commercial bank purchases of International Bank debentures within the present legal limits would be sure to have wide repercussions on the market for these securities. The singling out of these particular securities for unfavorable comment in connection with bank investment would inevitably have an adverse effect on their reception by those classes of investors (insurance companies, savings banks, trustees, individuals, etc.) who are regarded as the preferable repositories for them.

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Note on Effects of International Bank Operations Upon U.S. Money Market

The following note traces the technical effects which the International Bank's U. S. dollar operations would have on the U. S. money market during the initial stages of the Bank's development, i.e. during the period that it is building up its borrowings and its loan portfolio. The main text proceeds on the supposition that these operations will involve raising funds in the market only by the issuance of the Bank's debentures; the effects of operations by the Bank in guaranteeing issues by foreign obligors (now considered quite unlikely to attain substantial volume) are covered in brackets.

Let us make initially the simplifying assumption that dollar funds are concurrently raised by the Bank, disbursed by the Bank to foreign borrowers, and disbursed by the foreign borrowers in this market (directly, or indirectly via transactions with third countries). [In the case of guaranteed issues, it is assumed that the raising of the funds and their disbursement in this market is concurrent.] The money market effects of the Bank's operations may then be analyzed according to the source of the dollar funds which it uses for foreign loans.

(a) Use of dollars paid in on U. S. Government subscription (20 per cent of subscription). In view of the way in which these dollars will have been raised (i.e. by Treasury draft on war loan deposits), the net effect of their use would be deflationary in the narrow money market sense. The volume of bank deposits would remain unchanged, but deposits would have shifted from war loan account to the account of American suppliers of the export market, involving an increase of required reserves not accompanied by any increase in member bank reserves. If all of the dollars to be paid in by the U. S. Government ($635 million due in installments through next May) were lent out, the increase in required reserves (reduction in excess reserves) would be a little over $100 million.

(b) Use of dollars paid in on foreign government subscriptions (2 per cent of subscriptions).1/ In general these funds will be provided by draft on foreign accounts with the Federal Reserve Banks, and their transfer to American suppliers of the export market would increase both deposits and member bank reserves by the same amount, and also fractionally increase required reserves. If all dollars to be paid in on foreign government subscriptions were lent out, there would be an increase of about $90 million in commercial bank deposits and a net increase of about $75 million in excess reserves, largely offsetting the reduction of excess reserves under (a).

1/ A few small countries have paid in gold instead of dollars or have deferred payment, but the results are unimportant.

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(c) Use of dollars raised from sale of debentures to individual or institutional investors. The transfer of these funds from investors to American suppliers of the foreign market would produce no change in the volume of commercial bank deposits or reserves. /Same is true in case of sale of guaranteed issues./

(d) Use of dollars raised from sale of debentures to commercial banks. The provision of funds from this source would involve a corresponding expansion of commercial bank deposits and a fractional increase in required reserves. The theoretical maximum of commercial bank purchases of debentures is about $700 million under present laws, so that deposits might conceivably rise by this amount and required reserves by something over $100 million. To the extent that purchases were made by banks not holding excess reserves, the necessary reserves might be built up through sales of short-term Governments to the Federal Reserve Banks up to some fraction of the $100 million (plus) figure. /Same is true in case of sale of guaranteed issues./

Let us now assume that lags occur between the raising of funds by the Bank, the disbursement of the funds by the Bank to the foreign borrower, and the disbursements by the foreign borrower (directly or indirectly) to suppliers in the U. S. market. Such lags would tend to create an accumulation of funds at the Federal Reserve Bank of New York in the accounts of the International Bank or of foreign countries,1/ affecting the results stated above by correspondingly reducing commercial bank deposits and commercial bank reserves and hence causing pressure on the reserve position of the banks. /Same results follow in case of a lag between the raising of funds on guaranteed issues and their disbursement in this market./ However, while some such lags are likely to occur, in most cases where they are of substantial duration, they will probably be offset through action by the holder of the resulting balances (i.e. the Bank or foreign monetary authorities) to place them in short-term investments in the market. The conclusions stated above therefore remain substantially unaffected.

The Bank has already adopted the policy of investing in short-term Governments the 2 per cent payable in dollars on the capital subscriptions of all member countries, pending the use of such dollars on foreign loans. The other dollars which the Bank will receive from capital subscriptions (the remaining 18 per cent of the paid-in U. S. subscription) must be placed by the Bank for the most part in non-interest-bearing demand notes of the U. S. Treasury if they are not required for foreign loans (the Bank can reserve a small amount of these dollars for working purposes). In raising funds by the sale of debentures, the Bank will seek so far as possible to match the inflow of debenture proceeds against its disbursements on loans, possibly by making the purchase price of debentures payable in installments over a period of time. However, the avoidance of some lag may be very difficult, especially if the Bank feels that its

1/ Ignoring the possibility that to some minor extent the funds might accumulate in foreign deposits with U. S. commercial banks.

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loan commitments must at all times be covered by firm borrowings plus paid-in capital. While substantial lags may therefore occur, the Bank will undoubtedly seek to minimize its loss of interest from holding idle borrowed funds by investing in short-term Governments any balances which tend to accumulate.1/

No question arises of a lag between disbursement of funds by the Bank to foreign borrowers, and redisbursement by the borrowers, since under its Articles of Agreement the Bank can advance funds under its credits "only to meet expenses as they are actually incurred".

[In the case of guaranteed issues, lags are quite likely to occur between the raising and disbursement of funds by the foreign borrower, and precedent indicates much less likelihood that resulting temporary balances would be employed in short-term investment in this market. However, aside from the fact that the volume of guaranteed issues will not be large in this particular case there is a relatively good chance that any accumulated balances will be held by the foreign borrower with commercial banks rather than with the Federal Reserve Bank, thus leaving undisturbed the money market effects stated at the outset of this note.]

Probably the most serious possibility of an uncompensated lag arises in the case of dollar funds disbursed by the Bank to foreign borrowers and spent by them in third countries. At the present time, in view of the world supply situation, the bulk of such funds would probably be spent fairly rapidly on U. S. exports of goods and services. However, as time goes on, increasing proportions of such funds may tend to remain for longer periods of time in the dollar reserves of foreign countries. To this extent, as noted above, a movement of funds would occur out of the market and into the Federal Reserve Bank, bringing pressure on the reserve position of commercial banks.

[The same holds true in case proceeds from guaranteed issues are initially spent by the borrowers in third countries.]

1/ Another way of eliminating the effects of such a lag on the money market would be for the Bank to leave the proceeds of debenture issues with the commercial banks rather than transferring them to its account at the Federal Reserve Bank. While this device would also promote the Bank's good relations with commercial banks, it appears not to be permissible under the Bank's Articles of Agreement and its adoption would involve sacrifice of the earnings which the Bank might make by short-term investment of its funds.

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