BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 6, 1947

To Chairman Eccles

Subject:

From Mr. Knapp

I am very sorry to inflict upon you such a long memorandum as that attached, but the financing problems of the International Bank are complicated ones and I think you will feel as a member of the National Advisory Council that you should have a full knowledge of them. This is especially true because I raised some questions as to whether the Council is fully discharging its obligations under the Bretton Woods Agreements Act with respect to operations by the Bank.

Attachment

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BOARD OF GOVERNORS
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Office Correspondence

Date February 4, 1947

To Chairman Eccles

From Mr. Knapp

Subject: Investment in U.S. Government securities by the International Bank.

The prospect that the International Bank may be investing very large sums in marketable U.S. Government securities raises a number of important policy questions for the National Advisory Council and for the Federal Reserve System.

The dollar funds available to the Bank will consist of (a) the "2 per cent capital" paid in by all member countries, amounting at present to about 150 million dollars; (b) the "18 per cent money" contributed by the United States, amounting to about 570 million dollars; (c) the proceeds of debenture issues; and (d) net earnings of the Bank accumulated in the Special Reserve (which is to receive the 1 per cent per annum commission payable on all of the Bank's loans and guarantees) and in other earned surplus accounts.

Dollar funds from any of these sources which are not disbursed by the Bank on dollar loans may be invested by the Bank in U.S. Government securities. However, the U.S. "18 per cent money" cannot be invested in marketable U.S. Government securities since under the Articles of Agreement the Bank must place any of these funds which are not "needed in its operations" in non-interest-bearing demand notes of the U.S. Treasury. At present the Bank plans to lend out all of the U.S. "18 per cent money" and to derive its liquid dollar funds from the other sources (mainly from debenture issues in the early stages but eventually mainly from net earnings). The Bank will want to have liquid dollar funds available at all times for (a) meeting undisbursed commitments on dollar loans; (b) keeping up the service on its outstanding debentures (or guaranteed issues) if service on the underlying loans should be temporarily defaulted (this is the particular function of the Special Reserve), and (c) perhaps, engaging in open market operations in its own debentures and guaranteed issues. It appears to be the present view in the Bank that liquid funds of a billion dollars or more should be carried by the Bank for these purposes (at first mainly for (a), and later more for (b) and (c)).

Against this background, I should like to raise three important policy questions involved in the Bank's purchases and sales of marketable U.S. Government securities:

(1) Should the Bank's Articles of Agreement be interpreted to require direct approval by the National Advisory Council for such purchases and sales?

(2) If not, what other controls should be exercised by the United States over these operations--N.A.C. guidance to U.S. Executive Director? Consultation by the Bank with the Federal Reserve System?

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(3) Should the National Advisory Council try to get the Bank to arrange its accounts in such a way that its liquid dollar funds would be invested in non-interest bearing demand notes of the U.S. Treasury rather than in interest-bearing marketable U.S. Government securities?

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(1) Last October, when we first learned that the Bank had proceeded to invest in U.S. Certificates of Indebtedness the "2 per cent capital" paid to the Bank by all member countries in gold[1] and dollars, I raised the following two questions in the N.A.C. Staff Committee:

(a) What corporate power had the Bank relied upon for making these investments, and

(b) Why had the Bank felt that the formal consent of the National Advisory Council was not required, especially in view of the fact that such consent is required for several other kinds of securities transactions by the Bank in this market? (The Council had informed the U.S. Executive Director in July 1946 that it saw no objection at that time to the Bank's investment of the "2 per cent money" in U.S. Government securities if the Bank found that it had adequate authority to do so, but of course this did not constitute the giving of formal consent to the Bank by the United States.)

I took the position that these points should be clarified in order to protect the Council's record, preferably by a statement from the Bank. The Staff Committee agreed that it would be desirable to obtain clarification and the Treasury people suggested having their General Counsel consult with the General Counsel of the Bank on the matter. This was done and as a result the Treasury General Counsel prepared an opinion for the Staff Committee (N.A.C. Staff Document No. 135), which purports to answer my questions.

Mr. O'Connell's opinion concludes that although the Bank's Articles of Agreement do not specifically empower the Bank to invest in marketable U.S. Government securities (except in the case of funds from the Special Reserve),

[1] The small amounts of gold which were paid in--16 million dollars--were sold by the Bank to the United States.

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the Bank has an implied power to do so. He argues that this implied power is a well-recognized attribute of domestic corporations and that by analogy it should be enjoyed by an institution such as the Bank, which has a great many of the same characteristics as an ordinary corporation. Mr. O'Connell limits this opinion to the case of investment of the "2 per cent money", but there is no apparent reason why the conclusion should be any different with respect to the Bank's power to invest debenture money or earned surplus.

Mr. O'Connell further concludes that no stipulation in the Articles of Agreement specifically requires the consent of the United States for purchases or sales by the Bank of U.S. Government securities. This is clearly correct in the case of transactions with Special Reserve funds; but in the case of transactions with other funds, there is some slight ambiguity in the Articles of Agreement which Mr. O'Connell had to explain away. He seems to have done this quite successfully, and I think his conclusion is entirely defensible as far as it goes.

However, this further question arises: If there is an implied power of the Bank to invest in U.S. Government securities, is there not also an implied obligation to obtain the consent of the United States for such investments? Mr. O'Connell does not deal with this question. I believe, however, that a case can be made against implying such an obligation, as follows.

All transactions in this market for which consent of the United States is specifically required under the Articles of Agreement involve an international capital movement. For example, the United States, acting through the National Advisory Council, must approve:

(a) The issuance of debentures in this market;

(b) Purchases or sales by the Bank of its outstanding debentures in this market;

(c) Purchases or sales by the Bank in this market of foreign securities which it has guaranteed or which it has acquired in evidence of its foreign loans.

All of these transactions have the common characteristic that they involve foreign investment (or disinvestment in the case of purchases by the Bank) on the part of the United States. If, on the other hand, the Bank simply invests idle dollar funds in U.S. Government securities (or reverses the transaction), there is no international capital movement. The transactions may be regarded as analogous to the Bank's investment of its Special Reserve funds for which the consent of the United States is not required by the Articles of Agreement.

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I propose to put this argument into a memorandum addressed to the Staff Committee, and to request the Staff Committee to prepare a report on the whole subject for the information of the Council. Before doing so, however, I would like to get your support since the other members of the Committee have heretofore shown very little interest in pursuing this matter.

Query: Do you agree that it is important for the Council to review this subject in order to be sure that it is not neglecting its responsibilities?

(2) Assuming that the National Advisory Council does not have any direct control over the Bank's purchases and sales of U.S. Government securities in this market, there remains the problem of assuring by other means that these operations conform to (or at least do not conflict with) the policies of the authorities in this country. There are two ways of handling this problem: (a) through N.A.C. instructions to the U.S. Executive Director, and (b) through consultation between the Bank and the Federal Reserve System (the Open Market Committee) on any contemplated operations. Both have already been brought into play, but more or less independently, and I believe that a more clear-cut procedure should be established.

The Council started down the first path with its action of July 1946 (previously referred to), which reads as follows:

"The Council advises the United States Executive Director that it sees no objection at this time to the use of dollars received in payment of the first 2 per cent of the price of any member's share for the purchase of United States Government securities if the Bank finds it has adequate authority to purchase United States Government securities. The Council also sees no objection at this time to the Bank's disposing of such securities from time to time as the Bank sees fit."

Presumably Collado will again ask the Council for guidance when the Bank is ready to invest dollar funds other than the "2 per cent capital".

At the same time, precedent has been set for consultation by the Bank with the Federal Reserve System on such operations. During the Council's

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discussion of the action quoted above, Collado gave assurances that the Bank would consult with the System as to the timing of its operations, and I understand that when the International Bank asked the New York Bank as its fiscal agent to invest the "2 per cent capital" in Certificates of Indebtedness, Mr. Rouse informed the Open Market Committee and obtained its approval of the transaction. Furthermore, the New York Bank has put the International Bank on notice that its operations in our market must conform to System policy. In a letter to Mr. Meyer dated October 16, 1946 (copy received by the Board with Mr. Knoke's letter of January 17, 1947), Mr. Knoke made the following statement:

> "At this time it seems appropriate to reiterate a point of view with respect to our investing dollar balances for you, which Mr. Rouse referred to in a telephone conversation with you, namely, that we hold to the general principle that operations in this market of international organizations and foreign monetary authorities should conform in a general way to the monetary and credit policy of the Federal Reserve System, as otherwise it might be necessary for us at times to magnify our own operations in order to offset those here of such organizations and authorities. Accordingly, we are sure you will understand that, if at any time in the future the investment of your dollar balances in Government securities should run counter to Federal Reserve policy then prevailing, we would wish to feel free to advise you to that effect and, if we deem it necessary, to request that you allow any investments which we have made for your account to run off at maturity."

I have protested to Mr. Knoke concerning the serious delay which occurred in sending a copy of this letter to the Board (in fact, I think the letter should have been cleared here before it was sent), but I do not believe we should object to its content. The same language has been used by the New York Bank in writing to foreign central banks which have actively engaged in the purchase of U.S. Government securities in our market. We reserve our right to <u>request</u> (we have no legal basis for <u>demanding</u>) that these foreign banks, including the International Bank, cease to invest (or even to reinvest) in our market if their operations conflict with current System policy.

In the case of the International Bank, however, two independent authorities--the National Advisory Council and the Open Market Committee--are now in the position of reviewing proposed operations by the Bank. It seems to me that the only real purpose for this review is to determine whether these proposed operations are in conformity with our domestic monetary policy. Other questions with which the Council might conceivably concern itself (i.e. to what extent the Bank should invest its funds rather than hold them idle, what specific maturities the Bank should invest in, whether it should buy in the market or tender for new issues, etc.), seem to me to be merely matters of operating detail. Since three agencies on the National Advisory Council

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have nothing to do with the problem of domestic monetary policy (i.e. State, Commerce, and the Export-Import Bank), would it not be reasonable for the Council to delegate its authority in this matter to the Open Market Committee by instructing the U.S. Executive Director in the Bank that he is free to approve any operations by the Bank in our Government security market, provided that in each case the Bank ascertains (through the New York Bank) that the Open Market Committee has no objection to the proposed transaction on the ground of its effect upon our money market.

The only possible difficulty with this plan is that the Treasury does have a real interest in domestic monetary policy, but I wonder if the Treasury might not accept this delegation of authority if it were made revokable at any time; this would allow the Treasury to ask for the return of jurisdiction to the N.A.C. if at any time it disagreed with Open Market Committee policy in the matter.

Query: Shall I ask the Staff Committee to prepare Council action along the lines suggested above?

(3) A third question in connection with the Bank's investments in U.S. Government securities concerns the extent to which the United States should try to get the Bank to hold its liquid dollar funds in the form of non-interest-bearing demand notes of the U.S. Treasury rather than in interest-bearing marketable U.S. Government securities. As noted previously, it is the Bank's present intention to build up large liquid dollar funds (in addition to the Special Reserve) out of the "2 per cent capital", the proceeds from debenture issues, and from earnings; to invest these liquid funds in interest-bearing U.S. Government securities; and to lend out the "18 per cent money" contributed by the U.S. (570 million dollars) which might otherwise have to be placed in non-interest-bearing demand notes.

Under Article V, Section 12, of the Articles of Agreement, it is provided that the Bank shall accept from any member country non-interest-bearing demand notes in place of any of that country's capital contribution which is "not needed by the Bank in its operations". Furthermore, in the Bretton Woods Agreements Act the Secretary of the Treasury is authorized and directed to substitute demand notes for the U.S. capital contribution to the extent permitted by the Articles of Agreement, "for the purpose of keeping to a minimum the cost to the U.S. of participation in the Bank". The question arises, therefore, of whether the Bank can be said to need

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the U.S. "18 per cent money" in its operations at a time when it has liquid dollar funds temporarily invested in interest-bearing Treasury securities. If not, the United States could take the position that the Bank should make disbursements on dollar loans so far as possible out of funds other than the U.S. "18 per cent money" and invest this latter money in non-interest-bearing demand notes until it was needed for loans. (It might even insist that loans made out of U.S. "18 per cent money" at a time when no other funds were available should be "refunded" into loans from debenture money or other funds whenever such funds did become available.)

The Articles of Agreement of the Bank do not state whether the Bank or the interested member country should be the judge of whether or not that country's "18 per cent money" is needed by the Bank in its operations. But even if the Bank were assumed to be the judge, the question would remain of how the Council should instruct the U.S. Executive Director to vote on this issue in the Bank's Board.

I very seriously doubt whether in the circumstances described the Bank can be said to need the U.S. "18 per cent money" "in its operations". It certainly would not "need" the money for making loans, since it would have other dollar funds available for this purpose; and to the extent that it "needs" to hold liquid dollar funds as a reserve against various contingencies (see page 1 above), dollars invested in demand notes would be as good as (or better than) dollars invested in marketable U.S. Government securities. It has been argued that the Bank "needs" the U.S. "18 per cent money" in the sense that its use of this money for loans (and its investment of other funds in interest-bearing securities to maintain a liquid reserve) would enable the Bank to increase its earnings. The conclusion is certainly correct, but the argument seems a little far-fetched. The Bank will not stand or fall depending upon whether it earns nothing or, say, 1 per cent on the investment of its liquid reserves. Loss of interest in this form (amounting to, say, 5 million dollars a year if the Bank holds liquid dollar funds outside the Special Reserve in an amount equal to the U.S. "18 per cent money") could be offset by minor adjustments in the charges to borrowers.

Fortunately, however, there is one special circumstance which may make it unnecessary (or even unwise) for the Council to insist that the Bank use the U.S. "18 per cent money" as a liquid reserve rather than for loans. The Articles of Agreement provide that, if the Bank decides to distribute any net income (instead of accumulating it as earned surplus), the first charge on such distribution shall be a non-cumulative 2 per cent dividend upon the amount of capital contributions actually employed by the Bank for loans during the year. Thus, by following the course suggested, the Council might, while saving interest to the United States during the early years of the Bank's operations, debar the United States from receiving dividends later on. Obviously this country could "keep to a minimum the cost of its participation in the Bank" (the language of the Bretton Woods Agreements Act)

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by insisting that the U.S. "18 per cent money" be used by the Bank as a liquid reserve during the early non-profitable years, and then loaned out later on if it was expected that dividends would be declared. Equally obviously, such a maneuver would be unworthy of the United States, but the idea may suggest that if the Bank is now allowed to use the U.S. "18 per cent money" on loans, the Council should inform the U.S. Executive Director that it would oppose any future move to shift this money back into liquid reserves in order to avoid the payment of a prior dividend to the United States.

Query: May I have your views on this subject, and in particular your reaction to the suggestion contained in the last sentence of the preceding discussion? Consideration of this whole question is a matter of urgency since it involves the Bank's earnings and since the Bank must shortly establish the level of charges to be made to the initial borrowers.

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