BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 25, 1946.

To Chairman Eccles

Subject:

From Mr. Knapp

JBK

Probably the principal subject for discussion at the joint N.A.C.-Aldrich Committee meeting on Monday afternoon will be the flotation of International Bank debentures, and in particular the participation of commercial banks in this process, whether as investors or depositors. Mr. Collado would like if possible to talk to you on Monday morning on these subjects. I am attaching some material which you may want to look over in preparation for these meetings.

Attachments 3

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 25, 1946.

To Chairman Eccles

Subject:

From Mr. Knapp

WMK

Attached are two documents which have just been received as background for the meeting with the Aldrich Committee Monday afternoon.

(1) The first document is a reprint of a recent speech delivered by Mr. Aldrich, setting forth his general views on international economic policy. The speech is almost a model of the "liberal approach"; Mr. Aldrich favors reduction of trade barriers, stabilization of exchanges, abolition of exchange control on current transactions, free flow of international investment, etc. He endorses the objectives of the International Trade Organization and of the International Monetary Fund (stating that his earlier objection to the Fund was based on the feeling that the British problem had to be solved first). He also emphasizes the importance of reducing fluctuation in business activity in the United States both in order to maintain our demand for imports and in order to avoid "erratic fluctuations in capital exports".

Turning to the work of his Committee, Mr. Aldrich states that "Government or Government-sponsored loans should be supplemented and eventually replaced by private international financing", and adds that "the time is now ripe for the transition from Government to private international lending". He expresses the hope for an early expansion of direct investment abroad, pointing out that such investment does not burden the international balance of trade with contractual interest payments. He points out that the U. S. investor must receive assurance of fair treatment from foreign countries, but adds that the investor "must be willing to enter into partnership with local capital" in the foreign country.

(2) The second attachment is an internal memorandum prepared in the International Bank which has been forwarded to the National Advisory Council by Mr. Collado. It deals with the progress made in making the securities of the Bank eligible for investment by various classes of institutions. It reviews the early spadework done at the beginning of this year by the N.A.C. Technical Committee under Harry White, which produced the one tangible result of getting legislation in New York State making the securities eligible for investment by savings banks. It reviews the progress which has been made since that time in the education of various investment groups and various State supervisory authorities. All of this does not add up to very much in terms of concrete progress.

The paper then sets forth plans for action between now and next January when the more important State legislatures will again be in session. It explains that Mr. Collado has taken over the leadership in this campaign, and that he will make personal visits in several of the leading States to "lobby" for appropriate legislation. It is hoped that as far as possible leading institutions or institutional groups will take the initiative in proposing legislation, but in many cases it may be necessary to work directly upon the State supervisory authorities. Other groups which may prove helpful are the Bretton Woods Committee of the American Bar Association and the Aldrich Committee.

A few references are made in the memorandum to the problem of action by the Comptroller of the Currency declaring International Bank securities eligible for investment by national banks and to the problem of amending national laws and regulations to permit participation by commercial banks in the distribution of these securities. In this connection it is stated that "the National Advisory Council is planning to establish a small working committee to investigate and correlate the activities of principal Federal agencies having to do with the Bank's securities". At Mr. Collado's request, this committee (on which we are represented by Mr. Dembitz) has now been formed and is preparing some factual memoranda on the subjects mentioned above. I have asked that the existence of this committee and a statement of its functions be brought to the attention of the National Advisory Council.

Attachments 2

Distribution of International Bank Securities by Commercial Banks

Several commercial bankers, in discussing the market for International Bank securities, have suggested that Section 5136 of the Revised Statutes be amended to allow banks to act as distributors and dealers in these securities. At present, the law forbids such transactions by commercial banks except in the securities of the U.S. Government and certain of its agencies, and in State and municipal bonds. Since the performance of these functions by banks in relation to International Bank securities could conceivably be of great assistance to the Bank, the question of such an amendment needs to be given serious consideration.

There are three different functions which commercial banks could be asked to undertake in this field. They are (1) underwriting, or assumption of the risk that a given issue of International Bank securities will be successfully sold; (2) the distribution of new issues of the Bank on a commission basis without assuming the underwriting risk, and (3) dealing in the securities to maintain a market after they have been distributed. It is highly unlikely that the International Bank will seek underwriting services, but it will probably desire assistance from the market in promoting the sale of new issues and in developing an orderly market. The Bank will become in time the largest single issuer of securities in our market, aside from the Government itself, and broad distribution among investors will be necessary to assure successful flotation of its issues.

The present law on this subject was enacted as part of the Banking Act of 1933, and it appears to have had two principal purposes. One purpose was to add to the protection of the banks' creditors by preventing commercial banks from assuming undue risks in connection with security market operations. This, however, was clearly not the sole purpose, since even where a bank is permitted to buy given blocks of securities for investment, it is not permitted to buy the same securities for resale as underwriter or distributor. The other purpose was to assist in rationalizing our financial structure by separating functions that were considered incompatible. Thus it was desired to insure that the nature of a bank's investment portfolio would be determined by investment considerations rather than by the exigencies of a securities underwriting or distributing business; and to insure that customers who might apply to a bank for investment counsel or for credit accommodation would not find consideration of their case prejudiced by the bank's position as a seller of securities.

The State and municipal securities and securities of Federal Government agencies which are exempted from the law's limitations have two characteristics which served to justify this exemption: First, they are typically securities of relatively high investment quality; this tends to minimize underwriting risks, and it also tends to cause the underwriters' and distributors' "spreads" to be low, thus minimizing the incentive to a bank to indulge in undesirable practices in order to push sales. And second, the issuers of these securities are governmental as distinguished from private, so that there is no possibility that a bank might abuse its underwriting functions to assist an issuer in which officers of the bank had a personal financial interest.

These same characteristics would apply to International Bank securities, and might justify an amendment that would permit a bank to purchase these securities for distribution or dealing purposes up to the amount that the bank could legally hold for investment purposes. On the other hand, in view of the importance of the principles embodied in the present law, a departure in favor of International Bank securities should hardly be considered unless very important benefits to that Bank can be expected from it.

It is difficult to estimate how important it would be to the Bank to have the assistance of commercial banks as distributors and dealers in its securities. The existing investment securities houses already have widespread systems of branch offices, correspondents, and salesmen, which have proved adequate for the distribution of very large volumes of domestic corporate bonds, while the bond departments of banks (dealing in the restricted list of securities permitted by the present law) have few salesmen and reach a much smaller number of investors. The large banks point out, however, that they give investment information and assistance to great numbers of local banks, which in turn give information and assistance to their customers. The placing of adequate information in the hands of prospective purchasers is of great importance in the sale of securities of a new type, such as International Bank obligations, which conscientious managers of investment accounts will refuse to buy (regardless of price, yield or sponsorship) unless they feel that they fully understand them. While the banks might do much in disseminating such information even if they could not participate in distributing the securities, they would naturally do much more if they could also earn commissions as distributors. Probably only time will show how important this difference will become. Unfortunately, however, it is on the very first issue or issues that full scale commercial bank participation may be of the most importance, since these issues will probably be undertaken before most institutional investors have been authorized by State laws to invest in the International Bank's securities.

A few bankers have stated that their ability to act also as dealers, making a market for International Bank securities after they are issued, would assure a more orderly market for the securities, and thereby encourage both them and their correspondent banks to make investments in the securities. As dealers they would assist not only in the initial distribution of each issue but also in the subsequent process of directing the floating supply into the hands of strong permanent holders. It is again difficult to judge the extent to which the International Bank would benefit if banks as well as security houses were permitted to perform this function.

October 14, 1946.

Investment in International Bank Securities by Commercial Banks

When International Bank securities appear on the market, commercial banks will be able - under present Federal laws - to invest in such securities up to 10 per cent of their capital and surplus. Some banks will decide to invest in the early issues, perhaps up to the full 10 per cent limitation, while many banks may wish to wait until the new securities become more "seasoned." Some banks may hesitate to invest at first because of their uncertainty as to whether the securities will be considered by the Comptroller of the Currency to be eligible for bank investment.

The total volume of securities to be issued by the International Bank over the next five years may approach $7 billion. If the Bank adopts a policy of arranging the maturities of its obligations in a pattern corresponding roughly to the pattern of repayments due to the Bank from borrowers, most of the Bank's obligations will be long term. However, a very substantial amount (perhaps $2 billion) may have maturities of 10 years or less, and thus fall within the category of investments ordinarily considered appropriate for commercial banks. Under present laws, not more than $700 million could be taken up by the commercial banking system, even in the unlikely event that each bank bought the maximum permitted.

In connection with the present Federal bank regulations, there are two questions that will require the attention of the bank supervisory agencies -

1. When the first issue of International Bank obligations is about to be floated, the Comptroller of the Currency will undoubtedly be asked by some bankers whether he considers the obligations to be securities that are "not distinctly or predominantly speculative" and thus eligible for investment by member banks under the Comptroller's regulations. There seems to be no question but that the securities will meet this requirement; the question is whether the Comptroller should clarify the situation by answering such inquiries;

2. There may be proposed an amendment of the law to exempt International Bank securities from the 10 per cent limitation on bank investments. Congress has already given such exemptions to securities of such agencies as the Federal Land Banks and Home Loan Banks. The question will arise of the attitude the bank supervisory agencies should take toward such an amendment.

In connection with both questions it will be necessary, of course, to consider the relation of bank investment in these securities to the more general questions of the expansion and control of bank credit in the United States. A separate memorandum on this and related subjects is being prepared.

Statement by Comptroller on Eligibility.

It seems evident that the new International Bank securities will not be "predominantly speculative"; they will therefore be eligible for bank purchases under the Comptroller's regulation. As a practical matter, however, since the securities will be of a new and unfamiliar type, many bankers may tend to take a conservative attitude, and if there is any doubt as to whether purchases are permitted under the regulation, some prospective purchasers will defer action.

This subject has been discussed informally with representatives of the Comptroller's office, who agreed that the Comptroller could hardly object to bank purchases of the securities. The Comptroller would not want to issue any kind of public statement that might seem to be a recommendation of these securities. However, if a banker should make an appropriate inquiry when the securities are about to be issued, the Comptroller would probably give an answer to it, and his answer would undoubtedly spread rapidly among the banks.

After the first issue has appeared, the Comptroller cannot avoid letting bankers know that he considers the securities to be eligible, since the securities will appear in banks' portfolios, and the fact that their apearance there was not objected to by examiners will soon become known to bankers in general. Thus, on the great majority of the Bank's issues, commercial banks will not be in any doubt as to their eligibility; it is only the initial issue on which clarification by the Comptroller would affect the amount of bank purchases. The market reception of the first issue, however, will have a disproportionate effect in determining the atmosphere for the reception of subsequent issues. If there exists doubt among bankers as to eligibility, which affects the volume of bank investment in the first issue, it might lead to much greater adverse effects upon the future operations of the Bank.

If the rating agencies assign ratings to these bonds, that would assist bankers in determining their eligibility. However, there is not yet any indication whether or not the agencies will assign ratings initially, and there appear good reasons why the agencies should not be pressed to do so. The basis on which the rating system is founded is well designed for distinguishing between the quality of one railroad or industrial bond and another, or one municipal or foreign government bond and another, but it is not well suited for comparing bonds of entirely different kinds of institutions.

While there seems no questions that the new bonds of the Bank will be "not distinctly or predominantly speculative" it would be very difficult to determine exactly which one of the first four quality ratings is fairly applicable to them at this stage in the Bank's career.

Relaxation of 10 per cent Limit on Bank Investment.

Section 5136 of the Revised Statutes prohibits any national bank from investing more than 10 per cent of its capital and surplus in securities of any one obligor, and the Federal Reserve Act (Sec. 9) applies this same rule to state member banks. The purpose of the limitation was to protect a bank's creditors by preventing the bank from risking an undue amount, in relation to its capital funds, in any one situation. The statute exempts United States Government bonds, general obligations of states and political subdivisions and securities of certain Federal agencies such as the Federal Land Banks. The question arises whether the statute should be further amended to give a similar exemption to obligations of the International Bank.

Obligations of the United States Government are exempted because they involve no risk of the obligor's failure to make repayment when due. Exemptions are also provided for obligations of the Federal Land Banks and certain other Federal Government agencies and for State and municipal obligations; these exemptions might be justified on several different grounds: (1) they are the obligations of issuers whom Congress, in the public interest, desired to help; (2) the exempted securities are generally of comparatively high investment quality; and (3) since issuers of these securities are governmental as distinguished from private, there is no danger of improper use of banks' assets on behalf of particular private interests.

These grounds for the existing exemptions would also seem applicable to securities of the International Bank. An additional reason for special treatment of the International Bank securities lies in the nature of the assets behind them.

In the first place, while the 10 per cent limitation was intended to insure that the risk elements in a member bank's investment portfolio would be diversified rather than concentrated in issues of a single obligor, it should be observed that the International Bank represents in itself a diversification of risks. Each dollar of the Bank's liabilities will be covered in effect by two different sets of Governmental liabilities, since the liabilities of the Bank must be fully covered (1) by the Bank's assets in the form of loans, each made to a foreign government or to a borrower with foreign government guarantee, and also (2) by the subscriptions of the member Governments, 80 per cent of which can be called only when needed to meet the Bank's liabilities.

Furthermore, the United States subscription is large and amounts in effect to a United States Government guarantee of the principal of the Bank's securities up to at least 35 per cent of their aggregate principal amount. This percentage may be reduced by the admission of additional member countries, but can never be less than 27 per cent, and under certain circumstances, might prove to be considerably more than 35 per cent. For the remainder not covered by this U. S. guarantee, the liability of other member countries as subscribers to the Bank's capital will be divided among numerous countries with none having more than 16 per cent of the total, while the liability of member countries as obligors (or guarantors) on the Bank's loans will also undoubtedly show a wide diversification among borrowing countries.

For these reasons an amendment on behalf of these securities seems justifiable in principle. Instead of exempting these securities entirely from any limitation, it might be preferable merely to raise the figure from 10 per cent to some higher figure such as 20 or 25 or 50 per cent. A figure of 20 per cent would almost be justified by the U. S. Government guarantee alone; if a bank invested up to 20 per cent of its capital and surplus, the part of its investment not covered by the U. S. Government guarantee could not in any circumstances greatly exceed 10 per cent.

It may be possible to defer any decision on the matter, at least until the summer of 1947, because in the beginning the 10 per cent limitation will not exert any significantly restrictive effect on the International Bank's sale of its securities. Few banks would consider investing above the 10 per cent limit before the securities have begun to be "seasoned", and since the securities will be issued gradually, rather than in very large volume at any one time, a year or more may elapse before the 10 per cent limitation becomes seriously restrictive.

October 14, 1946.

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.

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 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.

October 17, 1946.

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.

(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.

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.