

C O P Y

January 19, 1940

Honorable A. A. Berle,  
Assistant Secretary of State,  
Department of State,  
Washington, D. C.

Dear Mr. Berle:

After consulting the Board and with its consent, I am sending you a memorandum containing some suggestions on the proposed Inter-American bank. This memorandum was prepared by Mr. Gardner in consultation with me, and I am entirely in accord with his suggestions, particularly that relating to the capital and control of the bank.

We both feel that in the discussion of the bank it would be desirable not to lay too much emphasis on the broader and more ambitious possibilities that might develop in the future, and to consider very carefully the exact place in the financial mechanism of the Americas that this bank can fill, together with the possible effects of the operations of the bank on particular countries.

I am sending a copy of this memorandum to Mr. White of the Treasury.

Sincerely yours,

(Signed)  
E. A. Goldenweiser,  
Director of Research and Statistics.

Enclosure

January 17, 1940

SUGGESTIONS RELATIVE TO PROPOSED INTER-AMERICAN BANK

We suggest for your consideration certain modifications in the plan for an Inter-American bank which has been under discussion by sub-committee one of the Inter-American Financial and Economic Advisory Committee.

Capital and control of the bank

The plan under discussion by the sub-committee provides for a government-owned and controlled bank dealing only with governments or those whom they recommend and guarantee. We should prefer to envisage a central bankers' bank enjoying continuity of policy and freedom to function directly in relation to its participating banks.

The question of who is to contribute the capital of the bank is relatively unimportant. In this country it would require Congressional action which could take the form of direct appropriation, or of authorizing the use for the purpose of existing Treasury resources, or of authorizing a subscription by the Federal Reserve banks or the Board. The contribution of capital need be no more significant from the standpoint of control than it is in the functioning of the Federal Reserve System or the Bank for International Settlements. Control can be separately determined, and its character is vital to the success of an Inter-American bank.

Since it is a banking institution that is being established, it appears logical that American representation on the institution should be through the Federal Reserve System, which is the banking arm of the Government. The Federal Reserve System has the institutional development and the personnel experienced in banking operations that equips it to discharge such a function. The fact that the Board of Governors of the Federal Reserve System is entirely a governmental body, and yet is more continuous than changing administrations, affords an opportunity for representation on the new institution from the standpoint of the public welfare without the risk from abruptly changing personnel. Considerations of this sort apply with even more force to Latin American countries in many of which Treasuries do not possess the personnel or the well-developed banking knowledge that is necessary to maintain an effective representation on the bank. Since the United States is certain to play a dominant rôle in the establishment of an Inter-American bank and since its decisions will tend to set the pattern for the Latin American participants, it is important that the type of representation adopted for this country should be capable so far as possible of generalization throughout the whole group. Upon the quality of representation we get from the various countries concerned will depend the success of the bank. A politically-minded group of directors

untrained in banking and giving most of their time between meetings to political issues at home could easily convert the bank into a source of serious embarrassment for the United States in its South American relations.

We would suggest for the United States a plan providing that the Board of Governors select the United States director on the bank (and his alternate) <sup>for some stated short term,</sup> subject to approval of the selection by the Treasury. This proposal would assure participation in the management through the banking arm of the Government and would also avoid possible difficulties that might otherwise arise in regard to the supervisory responsibilities over foreign banking relationships of the Federal Reserve System which Congress has imposed on the Board. At the same time it would make certain that ~~the selection of~~ the American representative <sup>selected</sup> ~~and the policies that he would favor~~ would be in <sup>accord</sup> ~~general~~ consonance with the viewpoint and general objectives of the administration.

A provision of this sort could readily be generalized to cover the whole group of participating American countries so that in each case the initiative would be taken by the central bank and representation by experienced bankers with a public viewpoint would be assured, subject to the ultimate control of the Governments concerned. It is evident from the discussions in the sub-committee, where the Latin

American members have definitely favored central bank representation, that a provision of this sort would come far closer to meeting the sentiment of the committee than would a provision which left the matter to the uncertain action of governments forced to take initiative in an unfamiliar field with perhaps the United States Government giving an example of passing by its central banking agency. From the standpoint of personnel, experience, and continuity of policy the suggested provision would seem to carry greater promise of an effective bank board.

#### Nature of the bank

We have had in mind a bank that would draw its funds from capital, deposits, and debentures and lend them both at short- and long-term. All the assets of the bank would have either central bank or government endorsement and be free of exchange control. The bank would thus have a special sphere of operations enjoying maximum safety and freedom. Care would have to be taken to provide that the bank would not by reason of its preferred position draw an undue amount of business away from existing commercial banks in Latin America or compete so vigorously with existing long-term issues of governments or mortgage institutions in Latin American countries as seriously to impair the <sup>market for</sup> ~~salability~~ of these issues. Care would also have to be taken to preserve the liquidity of the bank — a function partially discharged by reserve requirements.

Much of this viewpoint is embodied in the document now before the committee. We believe, however, that some sections still require clarification and that at other points superfluous provisions might well be eliminated.

Freedom from exchange control

Freedom from exchange control is one of the basic requirements of the bank. It was originally our hope that it could be provided by a simple provision in the convention to be approved by all countries stating that the government of each participating country exempts the bank's assets in that country from exchange control.

This is the form in which the idea was presented in the plan before the sub-committee. We were prepared to have the bank take the normal risk of exchange fluctuation. Even before the discussion in the sub-committee, however, we had come to realize that the provision would be inadequate for the reason that freedom to sell a

local currency on the exchanges may prove meaningless if <sup>the prospective</sup> ~~all others~~ <sup>private purchasers are subject to the exchange control.</sup> ~~dealing in the market are controlled.~~ The controlling authority

itself must be under obligation to supply the exchange, if necessary, and this requires the statement of some principle on which the rate in a controlled market shall be determined for the purpose of the Inter-American bank's operations. Our suggestion would be similar to the one which Mr. Berle made in passing during the discussion - namely, that each country shall agree that the assets of the bank in the currency of that country or payments due the bank in any currency from its

debtors in that country<sup>1/</sup> shall be free of exchange control and that the conversion of local currency into foreign currencies in this connection shall be on the same terms and conditions as those enjoyed by the most favored buyer of foreign exchange under the laws, decrees, and regulations currently in force. This would probably be a sufficient weapon to enable the bank to obtain the sort of freedom it requires. The bank would still be subject to the normal risks of exchange in so far as it dealt in local currencies, but neither the bank nor its debtors could be tied up by superimposed government exchange restrictions.

#### Liquidity of the bank

It is essential that the bank shall command the confidence of the public. If it is to lead the way in opening up a field in which private capital may ultimately be able to follow it, it must attract as much private capital to its operations as possible. It is hoped that Latin Americans who have deposited their funds in New York because of currency uncertainties will deposit in the bank instead and find their funds reinvested in their own countries; and that the bank's debentures will become a popular instrument of investment not only in Latin America, where they may attract funds that otherwise would go excessively into land or foreign securities, but

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<sup>1/</sup> This is to take care of dollar credits of which there may be many.

in the United States as well where surplus funds ~~are waiting a~~  
~~reasonably safe outlet.~~ For safe investment are available in large amount.

If the bank is to command confidence, however, its liquidity must be assured. In the plan now before the sub-committee there is no limit to the bank's assumption of liabilities other than such action as the Board itself sees fit to take. The plan requires the Board (at no specified time) to determine reserve requirements by a simple majority (permitting possibly a group other than the United States to determine them) and then makes them impossible of change without a 4/5 vote. The plan also requires a 4/5 vote for the issue of long-term obligations of the bank. Short-term liabilities can be freely incurred.

Although the veto power of the United States director will be considerable (assuming the United States to control 21 percent of the voting power), the arrangements above do not seem to be the best that can be devised. The more emphasis that has to be placed upon the sole veto power of the United States director the less the bank will function as a cooperative organization; and in any case the power is purely discretionary.



The depositor in the Inter-American bank and the investor in its debentures must be assured of two things: 1) that the bank will have an adequate capital and surplus to take care of possible losses from bad assets; 2) that the bank will have a sufficient amount of its good assets in the form of cash to take care of deposit withdrawals and <sup>of maturing</sup> ~~maturity~~ of debentures.

Action taken to meet the second requirement will in part meet the first, for the cash which the bank holds is an unshrinkable asset except for risks of exchange and it is contemplated that the bank's reserves <sup>will</sup> be in gold or dollars. Short-term assets of the bank, considering its privileged position, should also involve comparatively little risk. It is the intermediate and longer-term assets of the bank in which the main risk of loss is concentrated. Hence these longer term assets should be limited to some multiple of capital and surplus. The appropriate figure should come out of a careful appraisal by the sub-committee of the actual types of business the bank might be expected to do in Latin American countries and the degree of risk involved.

The reserve requirement, as has been noted, will in some measure assure the bank against shrinkage in its total assets, but its chief purpose is to provide cash to meet cash demands on the

bank. The conventional reserve requirement imposed on central banks, designed to prevent over-issue of currency or over-expansion of <sup>commercial</sup> bank reserves, is irrelevant to the Inter-American bank <sup>commercial</sup> as now conceived. The bank does not issue currency nor create bank reserves. It does need its own reserves for meeting withdrawals of deposits or maturities of debentures; but reserves that cannot be used because a given ratio must be maintained are of no avail. The plan before the sub-committee provides for rigid reserves of this character. It is true that the requirements can be changed by a 4/5 vote of all the directors. But to call the 21 directors together from all over the <sup>Americas</sup> ~~continent~~ when the cash is needed and get such a vote would be exceedingly embarrassing and calculated to breed public distrust.

We suggest that the reserve provision take the form of requiring the Board, whenever the bank's total holdings of gold, dollar deposits, and short-term dollar assets fall below a certain percentage of the bank's liabilities coming due within one year, to take steps to restore the ratio as promptly as is consistent with an orderly handling of the bank's business. This would allow the bank to make free use of its reserves, but it would compel it to

adopt banking policies that will ordinarily sustain its cash position at the stipulated level. The stipulated level should, of course, be only the minimum amount which the sub-committee after thorough consideration of the bank's business considers necessary for safety. The bank might be expected at its discretion to maintain somewhat higher reserves.

It would seem better to have reserves thus defined (there is no definition of what constitutes reserves in the present plan) and to have a safety minimum stated (with a flexibility provision that restores reserves after they have been used) than to order the bank board to tie its own hands in some way that the organizing committee cannot figure out. With this reserve requirement in the statutes and the limitation on earning assets relative to capital and surplus the prospective depositor or investor in the bank's debentures could see clearly the main framework within which the bank's operations would be held. Together with the provision for a central bank or government name on all the bank's earning assets and the guarantee against exchange control, this framework should go far to reassure him unless he is doubtful of the management of the bank.

Safeguards to existing markets

While it is highly desirable that the Inter-American bank should distribute its debentures widely in many countries of South America, thus providing a standard investment instrument, there is danger that the instrument might become too popular in some countries and make it difficult to sell government obligations and mortgage bonds in competition with it. The bank with its international preferred position might prove more attractive than the local bodies. It will probably be necessary to give each director on the bank the power to limit the issue of the bank's debentures in the market of his own country. Ordinarily if the bank reinvests in a Latin American country approximately the amount of funds that it draws from that country in subscriptions to its debentures, its activities would be recognized as beneficial. It might help to develop something of a local capital market and make local capital active in building up the country. But the power to prevent unwanted competition on a capital market already in existence should rest in the director from each country. A director might use the power to limit the sale of the bank's debentures in his country to a stated maximum -- a maximum which might later be increased. There is no such potential limitation on debenture issues in the plan now before the sub-committee.

Similarly there is danger that in accepting deposits from the public the bank might take a substantial amount of business away from local institutions or from branches of American banks in Latin America to which we have hitherto lent encouragement. It is important that the bank should be free to accept deposits from the public because therein lies its opportunity to gather up and invest back home those Latin American funds that have been deposited in New York to escape local currency uncertainties. But this purpose would be adequately served if the bank were permitted to receive deposits from the public in dollars only. Then the only deposits it would get would be those that otherwise would go abroad; for local business, local currency deposits would be needed. This would seem to be a better method of safeguarding the local institutions than would be a limit on the amount of deposits the Inter-American bank might accept. The bank could hardly refuse to accept checks for deposit in an existing account even though its limit had been reached, and it is always awkward to ration deposits. It is doubtful if the provision in the plan now before the sub-committee requiring government approval before the bank can accept a deposit (even a deposit from a central bank) would serve the purpose at all smoothly.

Hampering provisions

There are a number of provisions in the plan before the sub-committee which, like the requirement that the bank cannot accept deposits from central banks without the approval of the government, seem unnecessarily hampering. The provision that the Inter-American bank cannot make a short-term loan to a central bank unless the government of the country specifically recommends and guarantees the loan is of this character. And apparently the bank can rediscount central bank paper only for participating governments. There seems to be no adequate reason for these and other similar restrictions on the bank's business. It is desirable that the Inter-American bank should have as wide a field as safety permits. In particular it should have freedom to deal promptly in all types of business with the central banking institutions of the countries that comprise its market.

(Signed) E. A. Goldenweiser

(Signed) Walter R. Gardner