June 30, 1947.

To: Policy Group on Foreign Interests

From: Staff Group on Foreign Interests

Subject: Participation by System in Brazilian Stabilization Program.

Under the U.S.-Brazilian Stabilization Agreement, entered into initially in 1937 for a period of five years and renewed in 1942 for a further five years, the U.S. Stabilization Fund has been committed at any time to advance up to 100 million dollars to Brazil against receipt of an equivalent amount of cruzeiros secured by full gold collateral. Each advance under the agreement bears interest at the rate of 1-1/2 per cent per annum and is repayable at the end of one year (unless an extension of time is mutually agreed upon). This facility was used by Brazil in 1940 and again in 1941, but the dollar advances made at that time were repaid within brief periods. The agreement then remained dormant until recent months. However, commencing late in April, Brazil has requested a series of advances under the agreement which now aggregate 80 million dollars; it is expected that the remaining 20 million dollars will be requested by Brazil before the present termination date of the agreement, July 15 next.

Brazil has now applied for renewal of the agreement for a further period of five years. However, the Treasury, in view of the limited resources (about 280 million dollars) now available to the U.S. Stabilization Fund, is very reluctant to renew the agreement, at least for the full 100 million dollars. At the same time, the Treasury and State Departments are anxious at least that Brazil be offered some roughly equivalent alternative. Since the advances under the present agreement are secured by gold, it has occurred to Treasury officials that some way might be found out of the difficulty through resort to Federal Reserve loans on gold. This suggestion has been put before the Staff Group on Foreign Interests, which desires to offer to the Policy Group the following comments and recommendations.

\- - - - - - - - -

1. A complete answer to the problem would presumably be provided if the System were prepared to enter into an agreement to make loans on gold to Brazil paralleling the present Stabilization Agreement (but omitting of course the superfluous transactions in cruzeiros). However, such an advance commitment for a five-year period,1/ even though each actual advance under the commitment were to run for only one year, would go far beyond the present

1/ Actually the present agreement contains a clause permitting cancellation of the commitment on 30 days' notice; however, presumably this could not be invoked without some compelling reason and in practice it never has been invoked by the Treasury in any of its stabilization agreements.

System policy on gold loans. It would restrict the System's freedom of action in its credit operations, and would deny it an opportunity to review each loan application for evidence of speculative intent. (Although this latter point might be covered by a reservation in the agreement, such a reservation might be resented by Brazil.) On the whole, the Staff Group is not inclined to recommend this alternative.

2. Another alternative would be for the Stabilization Agreement to lapse, but for the System to take over the existing advance as of July 15 (presumably 100 million dollars) on its usual terms and conditions (i.e. on the basis of a three-month loan subject to renewal up to one year). Brazil would be informed that repayment would be expected by the end of one year, and that future requests for new loans on gold would be considered on their merits in the light of System policies prevailing at the time. This would give Brazil two minor advantages as compared with its present position: it would extend the maturity of the 100 million dollar advance to July 15, 1948 (as compared with serial maturities running from April through July 1948), and interest would accumulate at only 1 instead of 1-1/2 per cent. However, there would be a major loss to Brazil in the disappearance of any firm advance commitment for dollar advances against gold during the next five years.

The Staff Group would be prepared to recommend this action to the Policy Group if the State and Treasury Departments were to decide that this would be a suitable solution.

The Staff Group has some doubts as to the economic justification for a loan on gold to Brazil: while the Brazilians appear firmly to believe that the Brazilian balance of payments will develop so favorably as to permit repayment of the entire 100 million dollars within a year out of the proceeds of exports, the Staff Group regards this expectation as optimistic. Probably a major reason for the Brazilian Government's reluctance to sell its gold is its preoccupation with inflationary pressures at home and its fear that a decline in its published gold reserves would have unfortunate psychological consequences. However, Mr. Knoke's discussions in Rio indicated that some role is also played in Brazilian thinking by the belief that there may be an increase in the official dollar price of gold and a desire to retain gold holdings in order to profit from such a development.

Although the Staff Group has doubts as to the economic justification of the loan, and although it may well prove necessary to require the Brazilians to sell their gold at the maturity of the loan, the Staff Group recognizes this to be an unusual case since it would involve not a new loan but merely the transfer of an outstanding advance from the Stabilization Fund to the System.

3. As a third alternative, which would relieve the Stabilization Fund of part of its present large commitment to Brazil, and yet give Brazil

a "package" roughly as advantageous as what she has enjoyed before, the Staff Group suggests working out a formula along the following lines:

> (a) The System to make a 50 million dollar loan on gold to Brazil on the usual terms and conditions, refunding an equal amount of the present Stabilization Fund advance;
>
> (b) The Stabilization Fund to allow the remaining 50 million dollars of its advance on gold to run to maturity, to be replaced at that time by a 50 million dollar Stabilization Fund commitment to Brazil on the pattern of the recent commitment to Mexico (without gold collateral), provided that Brazil has by that time agreed upon its exchange rate with the International Fund and entered into normal relations with that institution. Subject to this latter proviso, and to the further limitations contained in the new agreement,1/ Brazil might be given the privilege of drawing upon the new unsecured credit to the extent that she repaid the advances from the Stabilization Fund under the old one. In effect, this would simply mean refunding the old into the new, thereby freeing the gold collateral.

An agreement as suggested under (b) above would clearly be feasible only if Brazil entered into normal relations with the International Monetary Fund. But once it has done so, it has a very good claim to as favorable treatment from this country as Mexico has received. It should be noted that the new "50 million dollar" Stabilization Fund commitment, though for advances without gold collateral, would be heavily qualified by clauses restricting Brazil's right to actually utilize the funds.1/

On the whole, the Staff Group believes that arrangements including (a) and (b) above would constitute an acceptable "package" for Brazil and would reduce to manageable dimensions the burden of Brazil upon the U.S. Stabilization Fund.

4. In Any case, the Staff Group would not at this time favor extension of more than 100 million dollars in U.S. credits to Brazil for stabilization purposes (aggregate of Stabilization Fund advances and Federal Reserve System loans on gold). This amount, plus Brazil's drawing rights on the International Monetary Fund (amounting to a total of 150 million dollars, or 37.5 million a year) should be ample for all legitimate currency stabilization purposes.

1/ See Appendix

Appendix

The Mexican agreement includes the following relevant provisions:

1. Advances of dollars are not to be made without prior consultation with the Secretary of the Treasury as long as the International Monetary Fund's holdings of the borrowing country's local currency are less than its quota (i.e. as long as the borrowing country has not drawn from the Fund the equivalent of its initial gold contribution).

2. Any advance of dollars which would bring total advances under the agreement to more than 10 million dollars is to require prior consultation with the Secretary of the Treasury.

3. Advances are to be repaid (with interest at 1-1/2 per cent) 18 months after the date upon which repayment is requested by the Secretary of the Treasury.

4. No change in the exchange rate is to be made without consultation with the Secretary of the Treasury.

5. Periodic consultation is to take place on matters pertaining to exchange rate, the purposes for which purchases of dollars have been made and problems of mutual interest therewith.

6. If in the operations of the agreement, there appears to be any inconsistency or conflict with the International Monetary Fund, consultation is to occur on the initiative of either party or the Fund.

7. If during the period of the agreement, either party ceases to adhere to the Articles of Agreement of the International Monetary Fund, the terms of the present agreement are to be reviewed.