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Questions and Answers
on the
Bank for Reconstruction and Development.

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Question 1

On what principles will subscriptions to the capital of the Bank be apportioned among member countries?

Reply

The authorized capital of the Bank is to be equivalent to about \$10 billion (II-1). The Bank is to be an international agency to whose capital all the United and Associated Nations will be expected to subscribe although, of course, member countries cannot subscribe equal amounts. Each government will, therefore, subscribe to a minimum number of shares to be determined according to an agreed formula.

The draft proposal sets up no necessary relationship between the capital subscription of a member country and the amount of loans which it may secure from or through the Bank. Nor is there any necessary relationship between loans made by the nationals of a member country and its subscription to the Bank. However, subscriptions of member countries will determine their relative share in the management of the Bank. An appropriate formula should, therefore, apportion subscriptions among member countries on the basis of their ability to provide capital for the Bank and the benefits they may expect to secure from the operations of the Bank. The draft proposal does not prescribe the formula for apportioning subscriptions but suggests that the agreed formula should take into account such relevant data as national income and the foreign trade of the member country (II-3).

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The ability of a country to subscribe to the capital of the Bank can best be measured by its national income. Obviously, the great industrial countries will have to provide the greater part of the capital of the Bank. They are, at the same time, the countries that are particularly interested in the maintenance of foreign investment as lenders of funds abroad and as exporters of capital equipment.

The maintenance of a high level of international investment will contribute to the growth of world trade. All countries, even those not directly involved in international investment, will benefit from the expansion of world trade that will result from the maintenance of the large and steady volume of foreign investment. The volume of foreign trade, therefore, will serve as a convenient indication of the benefit that member countries will derive from the maintenance of a high level of international investment after the war.

In testing various formulas based on these factors it was found that a fairly satisfactory apportionment of subscriptions could be secured by requiring each member country to subscribe an amount equal to 4 percent of its estimated national income in 1940 and 6 percent of its average annual foreign trade in 1934-1938. It might be desirable to adjust the subscription upward or downward by as much as 20 percent of the amount determined by the formula where the member country and the Bank conclude that such an adjustment would be equitable.

The formula proposed is tentative. It appears approximately satisfactory, but no doubt other factors could reasonably be included. There will be an opportunity for the technical experts of all participating countries to consider modification of the proposed formula.

Question 2

Will capital of \$10 billion be adequate for the Bank, particularly if only a small part of the capital subscription is to be paid in?

Reply

The capital of the Bank will serve two purposes; it will be needed to assure creditors of the adequacy of the Bank's resources and to provide working capital for its daily operations.

Because the Bank's principal function is to encourage international investment by private investors, the surety aspect of the Bank's capital will be of particular importance. The Bank will encourage international investment primarily by acting as guarantor on approved loans made by private investors. The effectiveness of the Bank's guarantee must depend on the confidence of the investing public in the capacity of the Bank to meet its liabilities. It is probable that a subscribed capital of \$10 billion will make it possible for the Bank to act as guarantor for two to three times this amount of loans without impairing the high quality of its guarantee.

The Bank will also require capital for making and participating in loans financed largely by private capital. Since these direct lending activities are expected to be only of secondary importance, the Bank's requirements for working capital will be comparatively small. Only 20 percent of the total subscribed capital will be paid initially by member countries. It is believed

that the two billion dollars paid in as capital will provide sufficient resources to permit the Bank to make or participate in loans in those cases in which the Bank's operations will take this form.

If the Bank should find it needs additional working capital, it would be possible to call for further payments on capital subscription, subject only to the limitation that not more than 20 percent may be called in any one year. The Bank, however, may prefer to acquire additional funds for its operations by issuing its own debentures or by borrowing from financial institutions in member countries. As discussed more fully in the answers to Questions 9 and 16, the issuing of securities by the Bank to raise funds for its operations would be one method by which private investors could provide, through the medium of the Bank, the capital needed for international investment.

It is not intended that the entire capital should be used directly in the operations of the Bank. The tentative proposal requires that a substantial portion of the subscribed capital shall be reserved in the form of unpaid subscriptions as a surety fund for its obligations as guarantor or issuer of securities. Since these funds are to be reserved for this specific purpose, there is no reason for imposing an unnecessary burden on member governments by requiring full payment of subscriptions. The assurance of adequate capital, so important to holders of securities

guaranteed or issued by the Bank, is fully provided by the obligation of member governments to meet the unpaid portion of their subscriptions.

It should again be emphasized that the primary function of the Bank will not be to provide loans directly out of its own resources but to act as guarantor of securities sold to private investors. Whatever lending the Bank does out of its own resources, either as a participant with private investors or as the sole lender, is expected to be small relatively to its operations as guarantor. For such purposes the paid-in capital of the Bank should be more than adequate.

The average annual gross volume of international investment by the leading industrial countries in the period from 1923 to 1937 was somewhat less than \$3 billion a year. A considerable part of this, perhaps as much as one-fourth, was in the form of direct investment for which funds were generally not raised in the capital market. It is quite probable, too, that if the Bank had been in existence it would not have undertaken to guarantee or lend on some of the issues that were floated in this period. Moreover, even with the Bank in operation a considerable part of all international investment will continue to be made directly through the usual investment channels without any recourse to the facilities of the Bank. Under the circumstances it would seem clear that even if the volume of international investment

should be greater than in the period from 1923-1937, a Bank for Reconstruction and Development with a subscribed capital of \$10 billion would have sufficient resources to facilitate and encourage the maintenance of an adequate volume of international investment in the post-war period.

Question 3

Why is it necessary to have any gold subscription to the Bank, or for the Bank to hold any gold resources?

Reply

The Bank must hold resources that will enable it to serve the interests of borrowers and lenders. This is possible only if the Bank holds sufficient gold to acquire the member currencies it may need. An adequate holding of gold will enable the Bank to maintain the liquidity it requires for its operations.

Where the Bank participates in loans or makes loans directly it will be necessary to provide the borrower with the currencies needed for procuring equipment and supplies. If the Bank could lend only in the currencies it holds, the borrowers might be restricted to obtaining their goods in the countries whose currencies happened to be available, even though more suitable equipment or better prices could be obtained elsewhere.

With its holdings of gold, the Bank could acquire the currency of any member country and make or participate in approved loans it would otherwise have to refuse. In this way it is possible for the Bank to avoid a type of bilateralism in capital transactions which may restrict trade and may involve uneconomical use of the borrowed money. Since the Bank is to "impose no condition upon a loan as to the particular member country in which the proceeds of the loan must be spent" (IV-7), it must hold some gold resources

to enable it to implement this policy. This point is discussed more fully in the answer to Question 6.

The Bank will also need gold occasionally to compensate capital-goods supplying countries for the adverse effects on their balances of payments which may result indirectly from the Bank's loans. To produce the goods required, some countries may have to import additional raw materials. For example, if China borrows from the Bank in order to pay for electrical machinery and equipment purchased in the United Kingdom, the loan (with the approval of the United Kingdom) would be in sterling, but Britain might need additional dollars or Chilean pesos to buy copper. Accordingly the Bank would furnish Great Britain, on request (IV-14), with foreign exchange or gold equal to an appropriate portion of the sterling loan.

In some instances a borrowing country might find that its need for foreign exchange, other than that required to pay for equipment for the loan project, has increased as a consequence of a developmental program financed with the aid of the Bank. The construction of an electric power plant would increase imports of electrical equipment and machinery that must be paid for with foreign exchange, or the construction of a railway would temporarily require the shifting of labor from the production of export goods. Although the loan would provide the foreign exchange needed in connection with the project, so that the investment program would

not directly affect the foreign exchange position of the borrowing country, the indirect effects could under some conditions temporarily disturb the borrowing country's balance of payments. Under such circumstances, the Bank may provide part of a loan in gold or needed exchange as the circumstances warrant (IV-8-d), as explained in the answer to Question 19.

The Bank must also be in a position to meet promptly its obligations to security holders regardless of the currencies in which they are due. Only in this way can the Bank retain the full confidence of private investors, which is essential to its successful operation. As guarantor on loans made to member countries through private investment channels, the Bank has a contingent liability which would come into force if the borrower defaulted. The Bank has a direct liability to the holders of securities it has issued for the purpose of raising funds for its lending operations. The Bank will, of course, have receipts as well as payments in the currencies of member countries. The holding of an adequate balance of gold would give further assurance that the Bank will always be in a sufficiently liquid position to meet its obligations.

For these reasons, it is necessary to provide the Bank with a balance of gold at the outset and to assure it a flow of gold from its operations. The proposed gold subscription will not be a burden to the members since it will vary with the members' holdings of gold and gold-convertible exchange (II-4-a) with,

perhaps, 20 percent as a maximum. The amount of gold payments will, of course, depend on the graduated scale adopted by agreement of the members. Assuming a 12.5 percent average, the initial gold subscriptions to the Bank would be about \$250 million. Aggregate gold subscriptions of this amount would be a very small part of the gold holdings of member countries. The Bank will be able to replenish its gold balance through the payment by borrowers of interest and principal which must be made in gold or currencies acceptable to the Bank (IV-10).

Every effort has been made in the proposal to avoid pressure on the gold and exchange reserves of member countries. The provisions for a moderate gold subscription and gold payments are intended solely to enable the Bank to perform the important functions for which it is to be established.

Question 4

What is the appropriate role of the Bank in the field of international investment? Will the Bank compete with private financial institutions?

Reply

The function of the Bank is to aid and encourage international investment through the customary private channels. Its appropriate sphere of activity is to assist private investors in meeting the needs of an expanding world economy. In the immediate post-war years capital will be urgently required for reconversion to peacetime production, for the reconstruction of destroyed areas, and for the development of economically backward regions. The revival of international long-term lending on an adequate scale is essential to the attainment of a high level of world trade without which world prosperity is impossible.

Private investors will be prepared to do some lending after the war. It is doubtful, however, whether unaided they will be willing to undertake more than a small part of the total investment required. In view of the losses suffered by international investors in some countries in the pre-war years, aid and encouragement will undoubtedly be necessary if adequate international long-term credits are to be provided by private investors. It is this specialized role which the Bank is to play. To the extent necessary, it will guarantee private investment abroad and thus encourage lending by private investors through the usual investment channels.

In some instances, it will lend directly, out of its own resources or by participation with private investors.

Procedures will be established to make certain that the Bank does not compete with private investment agencies and does not grant loans which can be placed in the private capital market on reasonable terms (IV-6). The selection of specific methods to assure the application of this principle would be left to the discretion of the governing board of the Bank.

The work of the Bank will be of great assistance to private investors. A competent committee under its auspices will investigate the loan projects for which the Bank's aid is requested. The committee will be especially concerned with the productivity of the project and with the anticipated balance of payments position of the prospective borrower. Methods will be employed to assure the use of the proceeds of the loan only for the approved purposes. The Bank will also make possible the extension of loans over a longer period than would otherwise be feasible. The schedule of repayment will thus be better adjusted to the character of the project that is financed. These services will be performed in connection with all loans guaranteed by the Bank as well as with loans in which it participates.

The Bank's operations as guarantor, participant, and lender will undoubtedly encourage private investors. Its guarantee may well become the mark of a high grade security appealing to a wide range of investors. The Bank's cooperation will be particularly

necessary in the immediate post-war period when private investors may be hesitant because of the heavy losses they have suffered on international investment in the past and because of the uncertain business conditions which may be expected to prevail for some time in the future. The defaults of the past did incalculable harm in generally discouraging international investment. The Bank, by reducing and sharing risks and by establishing standards for sound loans, will help to restore confidence in international investment.

Although the major part of the Bank's activities will be concerned with loans, it will also provide assistance in the equity capital market. The fact that the foreign loan capital required for a project will be available through the Bank should considerably facilitate the acquisition of the equity capital which may be necessary. Moreover, the Bank will offer active help to equity investment in two ways. It will obtain the guarantee of the national government that conversion of earnings on foreign held equity investments into foreign exchange will be permitted. It may also participate in equity investments itself, although its aggregate participation in such securities may not exceed a small portion of its paid-in capital (IV-4).

Question 5

What will be the relation of the Bank to post-war relief and rehabilitation organizations?

Reply

The Bank will not directly participate in post-war relief operations, in the sense of providing food, medicine, clothing and other supplies needed by the stricken populations of Europe and Asia. The direct relief task will require special agencies to deal with it. The United Nations Relief and Rehabilitation Administration has been established for this purpose, and its activities will probably be supplemented by private and public organizations in many countries.

The function of the Bank is to facilitate international investment for productive purposes. The loans it guarantees or makes must have favorable prospects of repayment. Without denying the urgency or importance of relief and rehabilitation, it is clear that the Bank cannot use its resources for this purpose. The Bank is to be a business institution whose resources are to be used to encourage international investment under prescribed safeguards in order to provide the necessary assurance to its creditors and shareholders.

In the immediate post-war period the Bank will facilitate the provision of capital for the reconstruction of the war-torn countries. In this way, it will aid in restoring their productive equipment and will permit the resumption of normal

employment for their workers. If adequate capital is available on reasonable terms, the total amount of relief expenditure can be greatly reduced and the period during which relief operations are necessary. greatly shortened. It is to the general advantage that the need for the dependence upon relief aid should be terminated as soon as possible and that the normal trade relations of the countries of the world should be restored. The Bank can be extremely helpful in bringing about the conditions under which such trade relations can be resumed.

Question 6

Will the Bank restrict member countries in their use of the proceeds of loans guaranteed, participated in, or made by the Bank?

Reply

The draft proposal accords member countries the maximum freedom in their use of the proceeds of loans consistent with the objectives of the Bank. Member countries initiate their own projects, borrow in whatever capital markets they prefer, and buy their capital goods where they wish. The conditions imposed by the Bank in making loans are only those which are essential to protect the Bank against loss and to reduce unnecessary disturbance to the economic life of member countries.

Each country will be free to direct investments into the type of undertaking which it regards as most important to its welfare. The facilities of the Bank will be available for industrial and commercial enterprises, as well as for government projects. However, where the borrower is a corporation or a municipality, the Bank will require the guarantee of the member government, its central bank or comparable agency. The Bank itself will apply no other tests to a proposed loan than to determine whether it will be productive and whether it can be repaid.

The borrower may also seek to raise the funds in whatever capital market is most advantageous. It is not the function of the Bank to direct loans into one capital market or another or

to restrict the capital markets of member countries in which the borrower may obtain funds, but it may not make or guarantee loans in any currency without the consent of the country concerned. It will merely aid the borrower by a guarantee of the loan when this is necessary to make the loan possible, if the loan satisfies the Bank's requirements.

Finally, the borrower is free to buy needed materials and equipment wherever it can procure them at the lowest cost or in the most satisfactory form. "The Bank shall impose no condition upon a loan as to the particular member country in which the proceeds of the loan must be spent" (IV-7). Where a loan is guaranteed by the Bank, the borrower is free to use the borrowed funds in any member country, provided the transfer of the funds has the approval of the countries concerned. Where a loan is made by the Bank, however, it will provide the borrower with the currencies required to pay for the purchases.

While the Bank will provide the loan in the foreign exchange that is needed (IV-8), it would not restrict the expenditure of the loan to the countries whose currency it has available at the time, since it can obtain other member currencies by the sale of gold or foreign exchange (IV-15-c). Moreover, provision is made for assistance to the borrowing and the lending countries in securing other foreign exchange if needed as a result of the loan transaction (IV-8-d, IV-14), as discussed more fully in the answer to Question 19.

In addition to the careful examination of loan projects submitted, the Bank must make arrangements to assure the use of the proceeds of any loan in which it is concerned for the purposes for which the loan was approved (IV-1-d). In the case of loans made by the Bank directly, this may be done by making payments only to meet drafts covering documented expenditures (IV-9). For guaranteed loans, somewhat similar procedures can be devised.

While member countries will be free to borrow and expend the proceeds of loans in any member country, the Bank does not limit the control that may be exercised by the lending and capital-supplying countries. A loan might affect business conditions in such countries by overexpanding production in boom periods or by acting on securities and foreign exchange markets. Through its member on the Bank board, a country may veto sales of securities in its markets, the transfer of borrowed funds to other countries, or the expenditure of loan funds at inopportune times (IV-8-a, 13, 15). These aspects of the problem are discussed more fully in the answers to Questions 16, 17, and 19.

A veto of this kind will not be used frequently or arbitrarily, since it will generally result in a reduction of exports. A capital-producing country probably will exercise this power only when the loan would have clearly undesirable effects on its own economy. In that case the borrower, of course, is free to obtain funds and to procure equipment in some other country where conditions are more favorable or where increased industrial output

is regarded as desirable. Since not all countries are in the same phase of the business cycle at all times, this should not be too difficult. In short, the borrower may secure a loan in any member country willing to lend and may spend the proceeds of the loan in any member country willing to sell the capital goods.

The provisions of the proposal are thus definitely designed to prevent the use of the Bank as a device for favoring the economic interests of any of its members to the disadvantage of others. It seeks to avoid, as far as practicable, bilateralism in capital transactions which is costly to the borrower and tends to restrict world trade. The limiting provisions included in the proposal have no other purpose than to safeguard the resources of the Bank, to assure the soundness of international investment, to permit member countries to protect their capital and exchange markets, and to prevent excessive investment during periods of business expansion.

Question 7

How significant will the guarantee of loans be in the operations of the Bank? Under what conditions will the Bank offer its guarantee?

Reply

The most important of the Bank's operations will be to guarantee loans in order that investors may have a reasonable assurance of safety in placing their funds abroad. In this way it is expected that the international flow of capital in adequate volume will be encouraged. In time, the guarantee operations of the Bank should help bring about the re-establishment of a ready market for foreign loans among private investors. Under any circumstances, private investors will provide the funds for loans guaranteed by the Bank, and such loans will be sold to the investing public through the usual investment channels.

Some countries, especially the larger ones, will probably be able to secure international loans in the immediate post-war period without the aid of the Bank. The Bank's guarantee, however, may be needed in other instances. First, the public may not be familiar with the position of the borrower and may be unable to determine the quality of the security. This would apply especially to smaller countries, municipalities and corporate enterprises. Second, the experience of the past two decades has brought foreign loans into disrepute among many

investors. Good risks are confused with bad risks in the investor's general impression of the doubtful character of foreign loans.

Certain conditions must be fulfilled before the Bank will facilitate any loan, whether by guarantee, by participation, or by direct lending.

- (1) The principal and interest must be fully guaranteed by a member national government (IV-1-a). That is, when the loan is made to a political subdivision or to a private corporation, the national government must guarantee payment in the event of default by the private debtor. This guarantee will serve as assurance that the international loan is regarded as in the interest of the borrowing country. Where advisable, the central bank or comparable agency may be substituted as the guarantor.
- (2) A competent technical committee of the Bank must submit a report in favor of the loan (IV-1-c). This report will be based on an analysis of the proposed project or program and of conditions in the borrowing country in so far as they relate to the prospects of servicing the loan. Loans will be approved only if they will serve to increase the productivity of the borrowing country and if the prospective balance of payments of the borrower is such that transfers of payments to foreign creditors seem assured.
- (3) The Bank's guarantee will be given only when the borrower could not otherwise obtain funds on reasonable terms (IV-1-b), and the Bank will make reasonable terms a prerequisite to its guarantee (IV-2-a). The term of the loan must be long enough so that the annual charges are appropriate to the purposes for which the loan is made and to the prospective balance of payments of the borrowing country (IV-1-e).
- (4) Finally, the Bank is to adopt procedures to see that funds loaned will not be diverted from the intended use (IV-1-d). These procedures may include such devices as inspection of construction, audit of accounts, or reports to the Bank.

The guarantee of the Bank will give the investor assurance that each loan has been thoroughly investigated to determine that it is sound from the point of view of the investor as well as the borrower. Furthermore, the borrowing country has assumed responsibility for payment of the loan. This is a responsibility to all the countries with whom it shares membership in the Bank, as well as to the lender. Finally, the resources of the Bank assure the lender that in case of default the guaranteed part of the loss will be met. The larger part of the capital of the Bank is specifically reserved in the form of uncalled subscriptions as a surety fund for this purpose.

The guarantee given by the Bank need not be the same for all loans. In some instances the Bank will guarantee in full both principal and interest payments. In others the Bank may guarantee principal or interest, or guarantee only part of these payments. The extent of the guarantee and the type of guarantee given will depend on the circumstances of the case. In general it is intended to give a guarantee sufficient to assure that the loan can be made at reasonable rates and on appropriate terms, without, however, assuming an unwarranted obligation on the Bank's part. This problem is further considered in the answer to Question 21.

Since the Bank is to be compensated for its risk in guaranteeing loans (IV-2-b), the fee paid by the borrower will depend on

the type of guarantee. Thus the fee might be a single payment made at the time the loan is floated, varying with the size of the loan, its term, the extent of the guarantee, the credit of the borrower and other relevant conditions. Alternatively, the fee might be made an annual charge payable at the interest dates. This fee could be based on the principal of the loan outstanding, and so would decrease as the loan is amortized. The precise methods by which the Bank is to be paid for its risk must be left to the discretion of its governing board who can adjust the terms to fit the circumstances of the particular loan.

Question 8

Why is a substantial portion of the subscribed capital reserved in the form of unpaid subscriptions as a surety fund for the securities guaranteed or issued by the Bank?

Reply

The guarantee operations of the Bank are intended to give assurance to private investors by reducing and sharing their risks. The Bank must also be in a position to borrow some private funds for the loans it makes or in which it participates with the public. In order to perform these functions satisfactorily, the institution must have large resources relative to its liabilities and it must be able at all times to meet its obligations as a guarantor and issuer of securities. Although a part of the subscribed capital of the Bank will be needed for current operations, a substantial portion will be required exclusively as a reserve that provides additional protection to private investors.

The ability of the Bank to engage in current operations will depend in large part on its assets consisting principally of member currencies, gold, and the securities in its portfolio. The attitude of the public to the Bank's guarantee and to the Bank's securities, however, will depend not merely on the resources it has in hand but even more on the resources it can call in as needed. As explained previously in the answer to Question 2, the unpaid portion of the capital subscription will be a surety fund that can be called for payment when funds

are needed by the Bank to meet its obligations on the securities it has guaranteed or issued (II-5).

Since the capital shares are non-assessable (II-2), such a reserve can be most conveniently held in the form of unpaid subscriptions, for in this way it is possible to make stockholders subject to call in case of emergency without increasing their total commitments. The shares are limited in liability in order that the maximum contribution of participating countries may be clear and definite at the outset. It would be possible to require full payment of subscriptions and then to employ part of the paid-up capital as a surety fund. To do so, however, would burden member nations without purpose, since the funds would be immobilized except under most unusual circumstances. Under the present provision, it should be noted, the Bank will be provided with this reserve at no current cost to the participating governments.

The unpaid capital held in reserve as a surety fund will provide assurance to the persons and institutions which have invested in the Bank's bond issues or in those which it has guaranteed. It will strengthen the Bank's position and increase its ability to assume obligations by the guarantee of securities at very moderate cost. The surety fund will give confidence to private investors and will make it possible for the Bank to raise funds from the public for its operations. Thus, the Bank should be able to carry on its operations successfully with a much smaller working capital than would be necessary

if a surety fund were not reserved to meet the direct and contingent obligations of the Bank.

Question 9

To what extent is it expected that the Bank will participate in loans placed through the usual investment channels? What disposition will be made of the securities acquired by the Bank through participation?

Reply

The Bank would not participate in the lending activities of private investors merely for the purpose of investing its liquid assets. It would participate only when and to the extent that its participation is required to place a loan in the private capital market, the largest possible part of every loan being made by the investing public. The principle laid down in the draft proposal, that the Bank will lend only when the borrower is unable to secure the funds from private sources, holds equally for the Bank's participation in loans made by private investors (IV-1-b).

The Bank's participation in loans is likely to be most important in connection with very large ventures. The ability of private investment agencies to secure the participation of the Bank should enable them to finance larger projects than might otherwise be feasible. The immediate post-war years will see the reconstruction of vast areas devastated by war and the need for financing of such projects by relatively large loans. In some instances the security markets might be unable to absorb an entire issue and might find it helpful to have the participation of the Bank.

In addition to its services in connection with large ventures, the Bank will also participate in loans when the market is not able to absorb a new security issue in its entirety. This need may arise when credits are extended to a country, or for a project, not sufficiently familiar to the general public to have more than a narrow appeal. Furthermore, if there should be only limited demand for a security, participation by the Bank may lend some of the Bank's prestige to the issue and thus increase its marketability.

It is also reasonable to expect considerable demand from the investment market for the Bank's participation and for its own securities in periods of depressed business conditions, both for the funds which can be obtained and for the prestige of associating issues with the Bank. Although private investors are less likely to undertake specific foreign investment at such times, they will probably lend to the Bank because of its position as an inter-governmental institution and because of the opportunity which its securities will offer for diversified foreign investment. As a result the Bank will be able to tap private loan funds, making them available to foreign borrowers through direct loans and participation.

The Bank may participate only when all the conditions required for direct lending or guarantees are met. These comprise a national government guarantee of interest and principal, an investigation into the productivity of the proposed development, and reasonable terms, including a schedule of repayment, adjusted to the life and

character of the project (IV-3). The Bank's participation will be indicative to the investing public that these conditions have been satisfied and that the loan is made with the aid and approval of the Bank. The Bank may participate in loans with or without guaranteeing the securities involved. If it should participate without guaranteeing the loan, the rate of interest paid to private investors would, of course, be higher than if the loan were guaranteed by the Bank (IV-3).

The securities acquired through participation will be retained in the Bank's portfolio only so long as they cannot be readily marketed. Since the Bank is not to be an institution primarily interested in investing its own funds, it will have no reason to hold these securities. They will be disposed of through the customary channels whenever private investors or investing institutions are ready to absorb additional parts of the issue. It is reasonable to assume that many securities, which for various reasons may not be immediately marketable, will become so in time. Furthermore, in order to facilitate the placing of such securities, the Bank may guarantee them (IV-5). By disposing of securities obtained through participation as rapidly as possible, the Bank will be fulfilling its primary goal of facilitating private international investment for productive purposes.

Question 10

To what extent will the Bank engage in direct lending? Will the Bank continue to hold the securities resulting from its lending operations?

Reply

The extent of the Bank's direct lending operations will depend on the ability and willingness of private investors to provide the capital needed for international investment. The Bank is not to compete with private investors (IV-6, IV-1-b) and it will make direct loans only when the private investment market cannot supply funds on reasonable terms even with the Bank's guarantee of the loans.

The Bank will find it necessary to make some direct loans particularly in periods of depression, when the private capital market is likely to reduce the volume of all investments, and foreign investments especially. Since loans can be most beneficial to both borrowers and lenders in slack times, the Bank can perform a very valuable function in maintaining international investment in such periods, as explained in the answer to Question 17. The Bank's guarantee may induce more private investment abroad in periods of recession than has been characteristic of the past, so that the Bank may not be called upon to make many large loans directly. It will be available, however, to supplement private sources when they are not in a position to make desirable loans.

Doubtless some loans will be made by the Bank even in prosperous

times. Investment bankers may not be interested in some small loans, for which the cost of underwriting and selling is too great in proportion to expected return. They may also be less interested in loans to small countries or small corporations abroad, whose securities would be more difficult to sell to their customers. Loans of this sort, however, may be entirely safe and extremely important to the country concerned, since they contribute to the development of its economy. By making such loans the Bank can perform an important function that would otherwise be neglected.

When the Bank lends directly it will receive the bonds or other obligations of the borrower, which it may hold in its portfolio or sell as circumstances permit. Its own funds will, therefore, be invested in direct loans for varying periods, depending upon the type of project, the credit position of the borrower, and the state of the capital market. If a loan is made at a time when securities can be readily sold in the market, the Bank may be able to sell the bonds from its portfolio rather quickly. When market conditions are unfavorable, the securities will have to be held for longer periods. Although this would not be the policy of the Bank, it may be compelled to hold some securities to maturity.

Sooner or later the Bank should be able to sell the larger part of its portfolio investments to private lenders on reasonable terms. Its procedure would be roughly analagous to that of the Reconstruction Finance Corporation, which took the bonds and notes of local authorities

and held them until the market situation had improved sufficiently for private investors to absorb the securities. This method not only provided funds needed for important local public works, which could otherwise not have been secured on the market, but also yielded the Reconstruction Finance Corporation a fair return on its investment. In the case of the Bank, the marketing of the securities can be facilitated by guaranteeing the issue at the time of sale.

As an alternative to sale of the obligations of the borrower, the Bank may issue its own securities (IV-15) and sell them to private investors, using the proceeds to make loans to member countries and holding the borrowers' obligations. In this way the Bank can consolidate a number of relatively small loans into a single marketable issue. Moreover, the Bank's direct obligations may be viewed more favorably by investors than the bonds of borrowers in some member countries, even though guaranteed by the Bank. The policy of the Bank would be to secure from private investors the greater part of the funds it lends directly. The Bank's own securities would, of course, be sold through the usual investment channels.

Question 11

Will it be possible to utilize the facilities of the Bank to meet needs for local funds by securing an international loan and converting the proceeds into local currency?

Reply

Borrowers through or from the Bank will not be able to use its facilities to raise local funds except under special circumstances. In general, the Bank is not intended to provide funds for expenditure within the borrowing country, even in the case of projects for which the foreign exchange needs are financed largely by the Bank (IV-8-b).

The Bank will not compete with the capital markets or commercial banks of the member countries in providing local funds for investment. In its lending operations it will provide an amount sufficient only for the necessary foreign purchases in the specific currencies required (IV-8-a). It will be further safeguarded by the regulations governing the use of proceeds of loans (IV-9).

As a rule, a borrower should obtain the local funds needed for an investment project from its own capital markets and should not depend on foreign loans to meet the need for local funds. It is generally a grave error to burden the balance of payments of a country with the servicing of a foreign loan when the needed capital can be raised at home. The facilities of the Bank should not be used for local

financing, although indirectly the availability of international credits will help a borrower in securing supplementary local funds. In the case of a project undertaken by a private enterprise, the funds will probably be obtainable from the sale of shares or bonds within the borrowing country. The raising of local capital by a government or a private business concern will be facilitated by the knowledge that the Bank will provide the foreign exchange required in connection with the project.

There will be occasions, however, when the Bank will find it desirable to make part of a loan in local currency. It will be prepared to do so when it finds that the domestic expenditures needed cannot be financed at home (IV-8-c). Such a situation may arise when the amount to be spent locally is relatively large and facilities for borrowing from private investors or from banks are undeveloped. Of course, where a developmental project will temporarily disturb the balance of payments position of a country, the Bank will provide for the foreign exchange needs which are an indirect result of the investment even though local expenditures bring about this temporary disequilibrium. Satisfying these requirements, however, will not generally entail the provision of foreign exchange to meet needs for local funds.

In the exceptional circumstances where the Bank decides that it is necessary to provide some of the local funds in connection with a developmental project, it would not in fact be necessary ordinarily to convert foreign exchange into local currency. This is certainly true of loans made directly by the Bank. The foreign exchange markets would not be affected when the Bank makes part of a loan in local funds, for the Bank would lend that portion to the borrower out of local funds held by the bank (IV-8-c). Under any circumstances, if exchange transactions become necessary in connection with loans through or by the Bank, they can be undertaken only with the approval of the countries concerned (IV-15-c). A fuller discussion of this point will be found in the answer to Question 19.

Question 12

What assurance is there that international lending will be on a sounder basis because of the operations of the Bank?

Reply

The operations of the Bank may be expected to have a wholesome effect on international investment by restoring the confidence of private investors in foreign securities. Although the Bank would not prevent loans from being granted on any basis agreeable to the parties concerned, the operations of the Bank would, nevertheless, tend to improve the quality of foreign loans.

It is reasonable to assume that the standards established by the Bank for its own lending activities will, over a period of time, have an effect on the attitude of private investors. These standards will focus attention on the importance both of the productivity of the project being financed and of a prospective balance of payments in the borrowing country favorable to servicing the loan. Emphasis will also be placed on a schedule of repayments appropriate to the life and character of the project. The written report of a competent technical committee, having no vested interest either as lender, borrower or intermediary, required by the Bank prior to the approval of loans, will help to assure the fulfilling of these conditions established for the protection of the investor.

The revival of international investment in amounts commensurate to the task depends upon the restoration of the confidence of private investors in foreign issues. It is unfortunate that in this country private investors have failed to discriminate sufficiently in the past between good and bad risks. The substantial losses which they suffered undoubtedly affected adversely international lending as a whole. The example of loans properly safeguarded should encourage private capital to go into international investment after the war.

The emphasis placed by the Bank upon the importance of reasonable conditions for international investments should also contribute to greater security on international loans. Too often loans bearing very high interest rates and short terms of repayment resulted in severe losses to investors. Such loans carried a deceptive compensation for risk, since the terms on which they were granted made repayment difficult. To this must be added the feeling of some borrowers that the terms were too onerous to meet. International investment can be maintained at a high level only if defaults are minimized. The Bank has the duty to protect both the borrower and the lender by stressing the necessity of high standards and reasonable terms on foreign securities. International investment can be maintained only when lenders and borrowers secure advantages from international investment.

Moreover, as discussed in the answer to Question 13, the Bank will have an overall picture of the loans contracted by a borrowing country which will be useful in discouraging excessive extensions of credit. Loans made with the Bank's assistance will also be safeguarded against default because of the strong moral obligation to fulfill commitments to the Bank and because of the economic consequences to defaulting countries. For further discussion see Question 15.

Finally, the Bank may be able to coordinate its lending policies to prevent large fluctuations in international investment. It will undoubtedly be able to effect a net increase in foreign investment during periods of depression, and it may also be instrumental in preventing excessive expansion resulting from international loans in a country experiencing a boom. The problem is considered in greater detail in the answer to Question 17.

Question 13

Will the Bank be able to prevent the excessive extension of credit to member countries?

Reply

One of the difficulties in connection with international investment in the past has been the tendency to extend excessive credit to some borrowing countries. No satisfactory quantitative test can be set up to determine whether an excessive amount of credit is extended to a borrowing country. The practical test must be this simple objective one: Can a borrowing country, including its political subdivisions and business enterprises, meet the servicing requirements of their foreign obligations even in periods of business recession? If they can, the conclusion must be that credit has not been over extended.

A number of provisions in the tentative proposal are designed to assure that on loans made through or by the Bank interest requirements and repayments of principal will be met. The underlying purpose of these safeguards is to protect the investor from making excessive loans and the borrower from undertaking excessive obligations. It is to the interest of both borrowers and lenders that aggregate international investment be maintained on a remunerative basis to induce private investors to continue to provide an adequate supply of funds for productive projects in borrowing countries.

The default of a foreign loan may come about because the borrower cannot obtain the local funds required for the debt service or because it is unable to arrange the transfer to the external creditor. To avoid these difficulties, the tentative proposal provides that no loan may be guaranteed, participated in, or made by the Bank unless a competent technical committee has made a careful study of the merits of the project or the program and concludes, in a written report, that the loan would serve to raise the productivity of the borrowing country and that the prospects are favorable to the servicing of the loan (IV-1-c). Emphasis is placed on the productivity of a loan, for it is the basic safeguard that a loan will provide the local funds or the foreign exchange required to service the debt.

It should be noted that one requirement on loans made through or by the Bank is that the national government, central bank or comparable agency must fully guarantee the payment of interest and principal on loans to political sub-divisions or business enterprises in the country (IV-1-a). One purpose of this provision is to secure the definite commitment of the national government to the transfer of funds for servicing the loan. A specific requirement to this effect is made in connection with equity securities that are placed with the aid of the Bank (IV-4).

If a loan is productive, the nation's capacity to produce will be increased and its capacity to develop a balance of pay-

ments surplus may also increase. Loans made for the development of the export industries directly will be most effective in this connection. Similarly, loans which diversify the commodity exports of a country may be expected to reduce the danger of adverse market conditions which sometimes burdened the single-crop-exporting countries in the pre-war period. It is not at all essential, of course, for a loan to be directly related to foreign trade, provided it is productive and the prospective balance of payments position of the country is favorable to the servicing of the loan.

No simple criterion can be used in determining whether the balance of payments position of a country will be favorable to the servicing of its foreign debts. There have been countries, such as the United States, which for long periods were borrowers abroad with a persistently adverse balance of payments on current account, although in part this adverse current balance was a reflection of their position as borrowers for investment purposes. In considering the capacity of a country to service foreign investments, the prospective balance of payments is more significant than the present balance of payments. Countries with a relatively large and growing export trade may be regarded as in a favorable position to service their foreign debts, even if for the time being they show an adverse balance on current account. In some borrowing countries tourist trade and other invisible items will be an important source of foreign exchange

and should be considered along with exports in determining the prospects for servicing foreign investments.

In considering the prospective balance of payments of a borrowing country, emphasis should be placed on aggregate foreign exchange receipts rather than on its net balance of payments. So long as a country has a flow of foreign exchange it can meet its contractual obligations, although at times this might necessitate a reduction in its imports. Where a country's imports do not consist predominantly of food and raw materials, a reduction in imports relative to its exports can be brought about through changes in the consumption pattern of the country. However, even in such a case there is some limit to the extent to which imports can be reduced in an emergency, and for this reason annual foreign requirements for debt servicing should not become too large as compared with gross foreign exchange receipts.

The technical committee of the Bank would undoubtedly take all such factors into consideration in determining whether the prospects are favorable to the servicing of a loan guaranteed, participated in, or made by the Bank. Obviously estimates of such matters must remain judgments made in the light of a continuously changing world economy. The judgments of the Bank directors, however, based as they will be on the careful consideration of all the relevant economic factors, are likely to be better than has been characteristic of judgments on the

soundness of investments in the past. When unpredictable circumstances make it impossible for a country to meet its foreign obligations for short periods, the Bank may accept local currency for periods of three years (IV-10-c).

Careful investigation along the lines suggested above should help prevent the extension of unduly large credits to member countries by or through the Bank. Undoubtedly, the action of the Bank will affect the attitude of private investors. When the Bank limits its loans to a particular country or refuses to guarantee further issues, it is likely that private investors will be less ready to lend to that country. In the case of member countries which do not require assistance from the Bank, the Bank will probably have no control over the amount of their borrowing or the purpose for which the credits are used. These, however, will be the countries whose loan records in the past indicate care in not over-extending their obligations.

Question 14

What reason is there for the Bank to facilitate loans which private investors are not prepared otherwise to make?

Reply

There are occasions when the Bank may properly facilitate loans to a borrower even though private investors would be unwilling to invest in such loans without the guarantee of the Bank. It is quite apparent from the experience of the 1920's that private investors are not always right in their evaluation of foreign loans. Just as they have at times made bad loans, so at other times they have refused to make sound loans. Lack of knowledge may make proper evaluation of foreign securities difficult for private investors. The Bank on the other hand, will have more complete knowledge of foreign investments and adequate facilities for the investigation of every loan placed with its assistance.

There is, furthermore, no reason to assume that the legitimate need for capital will always be met in full by private investors. The fact that funds are not available at a given time cannot be interpreted as evidence that the private capital market is unwilling to lend because the securities are poor risks. General market conditions, rather than the soundness of specific securities, are often the predominant factor in determining the volume of lending. Investors have loaned freely in boom years without regard to the merits of the investment or the prospects of

repayment. They have been reluctant to lend in periods of depression even to borrowers of high standing. The great variation in the volume of foreign investment is evidence of the importance of factors not related to the merits of individual projects requiring capital.

Changes of considerable amplitude in the volume of foreign lending occurred even during the prosperous years of the 1920's. For example, gross long-term foreign lending in the United States rose from \$1.2 billion in 1925 to \$2.1 billion in 1928. A major decline occurred during the period of depression when gross long-term foreign lending fell to less than \$300 million in 1932. It should be noted that during this period of depression, net foreign investment was actually negative because of the repatriation of American capital and the flight of foreign capital to this country.

The sharp decline in foreign investment during the 1930's is not an indication of the absence of opportunities for long-term productive investment. It is evidence, however, of the fact that at certain times private investors cannot be expected to lend abroad. In such periods even the best borrowers must go begging. If the legitimate needs of countries for capital imports are to be met regularly and with good prospects of repayment, an international institution capable of aiding and supplementing private investors is necessary.

It is a mistake to think of countries simply as good or bad risks for international loans. Every country is a sound risk for loans in limited amount for productive purposes. While private investors cannot assure themselves that the loans they make, though sound at the time, will not be impaired by excessive borrowing at a later time, the Bank is in a position to prevent such a development. It can keep the amount of loans made through or by the Bank at a conservative level, and make certain that such loans are used exclusively for productive purposes. Furthermore, as explained in the answer to Question 15, an international agency is in an especially favorable position for seeing that obligations on loans made through or by it are met by the borrowing countries.

Question 15

Why is an international agency necessary to encourage and facilitate the provision of long term credits for international investment?

Reply

There seems to be wide agreement that encouragement and aid is necessary if an adequate volume of international investment is to be maintained after the war. There has been some question whether an international agency is best suited for this purpose.

The provision of long term international credits affects every aspect of international economic relations. Unless an adequate supply of capital for international investment is available, it will be difficult to maintain the balanced growth of international trade. International investment facilitates the maintenance of equilibrium in the balance of payments and thus helps to stabilize exchange rates. Furthermore, world wide fluctuations in business conditions are to a considerable extent the result of large fluctuations in international investment. An international problem, so broad in scope and with such wide ramifications, can best be handled through an international agency such as the proposed Bank.

International investment is not confined to any one country. The large industrial countries of Europe as well as the United States have played an important role in the provision of capital for international investment. No doubt, as the result of the

war other countries, such as Canada, will for the first time become important sources of capital for international investment. The resources available for encouraging international investment can be most effectively used through an international agency embracing all countries.

The risks of holders of securities guaranteed or issued by an international agency are shared by all of the participating countries. The creditors on securities issued through or by the Bank would in a real sense include all of the participating countries who are guarantors of securities through their subscription to the Bank. A default on such securities becomes a default on a general international obligation to many countries and the measures that may be applied to the defaulters would be applied by all member countries.

If national agencies should be established generally for the purpose of encouraging international investment it is doubtful whether countries could altogether escape the use of their lending agencies for the purpose of furthering national political interests. The extension of credit to a particular country becomes a political matter to be settled by negotiation between the borrowing country and the lending country. Even if such political considerations could be kept to a minimum, it is doubtful whether national agencies would

be as helpful as an international agency in developing international trade and removing the restrictive bilateralism that grew up in the decades before the war.

The provisions of the Bank proposal are designed to safeguard the national interests of member countries. No loan can be made nor can any securities be sold by the Bank in a member country without its approval. No exchange transactions can be undertaken in the currency of a member country without its approval. These provisions are intended to make sure, as explained in the answers to Questions 16 and 17, that the operations of the Bank do not adversely affect the capital, money and exchange markets, or business conditions in member countries. The determination of policy on these matters is completely reserved to each member country.

An international agency working in cooperation with national authorities can be most effective in encouraging private investors to resume international investment and provide adequate capital for productive purposes. The operations of such an agency can do much to contribute to a higher level of world trade, a greater degree of stability in exchange rates, and fuller employment in all member countries.

Question 16

How will it be possible to prevent the operations of the Bank from having an adverse effect on the security markets and money markets of member countries?

Reply

The provisions of the proposal for a Bank are designed to prevent disturbances in the security markets of member countries as a result of its operations. Each member country has a safeguard against undesirable action in the requirement that securities may be sold in its markets only with the consent of its representative on the Bank board (IV-15-a).

In its operations the Bank proposes to utilize as fully as possible the facilities of the investment markets. It is expected that its main function will be to guarantee securities representing productive loans made in the usual way by private investors to member countries, their political subdivisions or business enterprises. As explained in the answer to Question 10, even when the Bank lends directly to borrowers in member countries, it will receive the borrowers' obligations and hold them for subsequent sale through the usual investment channels when market conditions permit. If the Bank issues its own obligations to secure funds, it will also dispose of them through the investment market.

Because the Bank's operations are intended to assure the provision of investment funds directly or indirectly through the

capital market, it is essential that the operations of the Bank should not have disturbing effects on the security markets. The Bank itself will undoubtedly be concerned to see that the foreign loans it facilitates do not deprive domestic borrowers of the funds they need for domestic investment. In the last analysis, however, dependence must be placed on the member country to inform the Bank when its operations have an undesirable effect on the capital market. In accordance with IV-15-a and other provisions, member countries can prevent the sale in their markets of securities originating from the Bank's operations.

It is conceivable, too, that the operations of the Bank could affect the money markets of member countries. This would be particularly true of the direct loans of the Bank, if the Bank's holdings of a member currency were kept as a deposit with the Central Bank. Under such circumstances, the expenditure of a loan made or participated in by the Bank would result in an increase in the reserves of the commercial banks. Similarly, the payment of interest or principal on securities held in the Bank's portfolio would tend to decrease the reserves of the commercial banks.

There is still another way in which the operations of the Bank could affect the money markets of member countries. If the securities guaranteed by the Bank or issued by the Bank were bought or sold in any considerable volume by commercial banks

it would, of course, increase or decrease the volume of deposits and affect inversely the volume of excess reserves. Under such circumstances, the availability of bank funds for domestic borrowers would depend in part upon the attitude of the commercial banks toward securities guaranteed or issued by the Bank.

Obviously, every effort should be made by the Bank in its operations to avoid any direct effect on the money markets of member countries. Monetary policy must remain wholly within the control of the national monetary authorities. The Bank can minimize the effects of its operations on the money markets by predominant use of guaranteed loans rather than direct loans out of its own funds. The Bank would, of course, cooperate with the Central Bank and the monetary authorities of a member country so that its operations would not offset measures intended to make the monetary policy of the country effective. Under any circumstances, it is within the power of a member country to prevent the Bank from guaranteeing, participating in or making any loan in its currency without its consent (IV-13).

Question 17

How will it be possible to prevent the operations of the Bank from intensifying the effects of excessive investment in boom times and deficient investment during depression?

Reply

The operations of the Bank in facilitating international investment are certain to affect business conditions in the borrowing and lending countries and, indirectly and to a lesser extent, in other countries. It is important, therefore, that the operations of the Bank should not be of a character tending to accentuate the forces of expansion during boom or the forces of contraction during depression. On the other hand, the Bank can aid considerably in stimulating production in periods of business depression and it can cooperate with central banks and governments in their attempts to check excessive expansion in periods of business prosperity.

The expenditure of the proceeds of international loans, whether made by private investors or by the Bank, will affect production in the country receiving the loan as well as in the country supplying capital goods. An international loan for the purpose of acquiring capital equipment abroad will generally tend to encourage domestic expansion. The investment project for which the foreign loan is made is certain to involve in part domestic outlays for labor and local materials, even if much or all of the essential equipment comes from abroad. The effect will be to increase the income and expenditure of domestic labor and so contribute to industrial expansion.

The loan will also stimulate an expansion of production in the countries supplying the capital goods. The production of new capital equipment will require additional labor and raw materials. The increased employment in heavy industry will in turn increase the demand for consumer goods. The effect of international investment on business conditions is particularly important since the heavy industries are subject to rather extreme fluctuations in the demand for their products.

The effects of foreign investment are obviously not entirely confined to the borrowing and lending countries. The higher level of employment and income resulting from such investment necessitates increased imports of raw materials for production and finished goods for consumption. The aggregate volume of foreign trade is increased and all countries engaged in foreign trade feel the indirect effects of international investment.

Because of its importance, it is desirable to prevent excessive fluctuations in the aggregate volume of international investment. It would be most unfortunate if the operations of the Bank were to result in excessive international investment during a period of world-wide prosperity and a sharp contraction of international investment during a period of world-wide depression. Large fluctuations in international investment in the 1920's and 1930's undoubtedly contributed to the sharp decline in international trade and to the severity of the depression in the 1930's.

The problem of maintaining international investment at an

appropriate level is not only concerned with the aggregate amount of international investment but also with its distribution among member countries. The great industrial countries, which are the principal source of funds for foreign investment and the principal producers of capital goods, are themselves subject to booms and depressions of large amplitude related to fluctuations in the volume of domestic investment. The operations of the Bank must be coordinated with business conditions in such countries. For obvious reasons, domestic investment must be given precedence.

The international character of the Bank is particularly important in relation to the maintenance of adequate but not excessive international investment through the course of the business cycle. Business is not always in the same phase of the cycle in all countries. The Bank can avoid accentuating a boom in a capital producing country by facilitating loans in other countries with available labor and unused industrial capacity. Moreover, by encouraging international investment at the beginning of a recession the Bank may aid in avoiding a more serious breakdown, which would have world-wide repercussions.

The Bank itself will undoubtedly take into consideration business conditions in the lending and borrowing countries when passing upon applications for loans to be guaranteed or to be made by the Bank.

The primary dependence on private investors for loanable funds will to some extent tend to check excessive investment in periods of expansion, for at such times interest rates will tend to be

relatively high. However, complete reliance cannot be placed in such checks, as previous experience has proved. The Bank should determine its policy on international lending with reference to world-wide business conditions. It should maintain the closest cooperation with the Central Banks and the monetary authorities of member countries. Ultimate responsibility to assure that international investment does not induce excessive expansion in a member country must depend on its own monetary authorities. Under the provisions of the proposal the Bank must give due regard to the effect of a loan on business and financial conditions in the country in which the loan is to be spent and must obtain the consent of the country affected (IV-13).

Question 18

What will be the relationship between the proposed Bank and the International Monetary Fund?

Reply

The Bank and the International Monetary Fund are both needed to help solve the international monetary and financial problems that will confront the world in the period after the war. While the two agencies will cooperate with each other in many ways, each has distinct functions of its own to perform. The Fund has been specifically designed to promote currency stability, whereas the Bank is intended to facilitate international investment for productive purposes.

The establishment of the Bank would simplify the task of the International Monetary Fund, and the successful operation of the Fund would enhance the effectiveness of the Bank. The existence of one, however, is not essential to the other. Each could stand and function alone; together, they could make a more significant contribution to the development of world prosperity. It is hoped that all the United and Associated Nations will participate in both organizations.

Although each agency could exist alone, the establishment of the Bank and the Fund would be helpful to both institutions, and would facilitate their successful operation in the immediate post-war period and the years thereafter. The loans made with the assistance of the Bank will expand the volume of foreign trade and thus improve the opportunity for all countries to maintain a balanced position in

their international accounts. The extension of long-term credits will be less variable, as explained in the answer to Question 17, and the existence of the Bank should help prevent the reappearance of the large unstable short-term indebtedness which was in part a result of an unwillingness to invest at long-term, as explained in the answer to Question 19. The Fund, in turn, will decrease the risks of foreign investment by minimizing disorderly fluctuations in exchange rates which have discouraged long-term foreign loans. It will help to eliminate foreign exchange restrictions which, by preventing the withdrawal of income earned on investments, have seriously deterred international lending.

In the course of carrying on their separate activities the Bank and the Fund will cooperate and consult with each other on matters of joint interest. The Bank may find it necessary on occasion to buy or sell foreign exchange as part of its operations. It will undertake such transactions after consultation with the International Monetary Fund and only with the approval of the countries concerned (IV-15-c). Furthermore, in so far as the Bank converts gold into member currencies needed for its operations, it may choose to do so through the Fund.

It is clear that the two major financial problems of the post-war period are closely interrelated. Currency stabilization cannot be completely separated from the provision of long-term international credits. The two institutions designed to deal with these problems will find that cooperation between them is essential. Together, they can help to provide a sound financial foundation for a prosperous world economy.

Question 19

Will the Bank's operations facilitate the maintenance of equilibrium in the balance of payments and thus help to stabilize exchange rates?

Reply

The operations of the Bank will generally contribute to the maintenance of equilibrium in the balance of payments of both lending and borrowing countries.

Short run equilibrium in the borrowing country is facilitated because international loans enable it to purchase capital goods on credit, where it might otherwise be compelled to employ an excessive part of its gold and foreign exchange resources to pay for such imports. International investment helps prevent the development of pressures on the exchanges that might necessitate exchange control and similar restrictive measures designed to force a balance in a country's international accounts or an undesirable alteration in exchange rates to offset a temporary disequilibrium.

Long run equilibrium in a borrowing country's international accounts is facilitated by investments that increase its productivity and capacity to export relative to its import needs. For example, international investment for the development of the iron ore deposits of Brazil or the petroleum resources of Venezuela and Colombia will increase the exports of these countries, with the proceeds available for both debt servicing and additional imports.

One of the most difficult problems of some debtor countries has been the great fluctuation in their foreign exchange receipts resulting from excessive dependence on one crop. Loans which would diversify their output and their exports would clearly be helpful in maintaining a greater degree of equilibrium in their balance of payments.

Foreign loans extended for the purchase of capital equipment will help restore equilibrium in the balance of payments of a country whose current accounts are already favorable. Some exports of capital equipment that would otherwise have been paid for by an inflow of gold or the accumulation of balances abroad would be paid for with the proceeds of the loan. Furthermore, foreign investment by a country with a favorable balance of payments will increase exports, production, and income at home, and bring about an increase in imports of raw materials and consumption goods which will contribute further to the balancing of its current international accounts. In the long run, the maintenance of equilibrium in the balance of payments of the capital exporting country must depend on the adjustments in reciprocal demand that grow out of the development of the productive resources of the borrowing countries.

Where a loan is made in one country and expended in others, the transaction could be disturbing to the foreign exchanges if the favorable balance on current account of the lending country were less than its new foreign investment. The draft proposal safeguards against such a development by providing that the Bank must take into consideration the effect of a loan on financial conditions

in the lending country and must obtain the consent of the country concerned (IV-13). Furthermore, the Bank may not buy or sell foreign exchange except with the approval of countries concerned (IV-15-c).

Countries not directly concerned as borrowers or lenders are also likely to benefit from a larger volume of international investment. As explained in the answer to Question 17, the level of production and income in the borrowing and lending countries will rise with more international investment. At the higher level of production and income, their imports will also increase. All other countries not directly concerned as borrowers or lenders will be affected by the increased demand for their export goods and will consequently find their balances of payments on current account more favorable than they would otherwise be.

Although the general effect of international investment is to facilitate the maintenance of equilibrium in the balance of payments on current account, there may be some instances in which this will not be so. Where investment is undertaken with the aid and encouragement of the Bank, provision is made to offset the resulting adverse effects on the balances of payments of the member countries concerned.

If long-term credits are extended by a member country with an unfavorable balance of payments, the loan may temporarily increase the disequilibrium in its position. Of course, the loan may result directly in an increase of an equal amount of exports and this will

tend to limit the adverse effect on the balance of payments. Furthermore, the Bank will repurchase for gold or foreign exchange a part of the local currency spent in the lending country (IV-14). With the application of this provision, a country will find that its balance of payments will not deteriorate as a result of loans made through or by the Bank. Again, it should be emphasized that loans cannot be made through or by the Bank without the consent of the country concerned (IV-13).

The Bank's assistance may also be needed to help maintain equilibrium even when a lending country invests abroad no more than its favorable balance on current account. Increased exports of capital goods stimulated by long-term lending may increase the level of production and income in the lending country, with a consequent rise in imports of raw materials and consumers' goods. This indirect effect on the balance of payments is the same whether or not the Bank is a guarantor or participant in an international loan. However, in the case of loans through the Bank, the exporting country will be protected against difficulties of this kind by the provision that the Bank will repurchase for gold or foreign exchange a part of the local currency spent in the lending country.

Provision is also made to offset any tendency to increased disequilibrium in the balance of payment of the borrowing country which may temporarily arise as a result of loans through the Bank. A country importing capital for a developmental program may find its trade position impaired for a short period because of augmented imports induced by a rise in the national income or by the diversion

of labor to the new project which necessitates imports to compensate for decreased consumers' goods output. A nation undertaking extensive capital improvements may also for a time divert capital and labor from the export trades. Obviously, the pressure on the balance of payments from such forces must be of a temporary character or there would not be a sound basis for extending foreign loans. The Bank in making loans agrees that "whenever the developmental program will give rise to an increased need for foreign exchange for purposes not directly related to that program yet resulting from it, the Bank will provide an appropriate part of the loan in gold or desired foreign exchange" (IV-8-d).

Special consideration is given to the problem of servicing of loans made with the Bank's assistance so that it will not cause disequilibrium in the borrower's balance of payments. Protection is given through the requirement that loans must provide for a schedule of repayment appropriate to the character of the project and the balance of payments prospects of the borrower (IV-1-e). To the extent that the debt service is geared to the life and nature of the capital project, repayment may be feasible out of the increased productivity and export surplus resulting from the loan, without straining the country's balance of payments. In the event of an exchange stringency the Bank may permit payment of interest and principal in local currency for brief periods (IV-10-c). To protect the Bank, the borrower must arrange for the repurchase of such currency.

The Bank will improve the general prospects for achieving equilibrium in the balances of payments of the major trading countries by preventing drastic declines in the total volume of foreign lending. There can be no doubt that the general effect of international investment is to help maintain equilibrium in the balance of payments of debtor and creditor countries; but when the world has become adjusted to a given level of international investment, a large and sudden reduction in the volume of international investment can be extremely disturbing. The Bank can help to maintain a greater degree of stability in the provision of capital for international investment.

Question 20

What provision is made to assure the Bank against loss from exchange depreciation? What provision is made to prevent undue hardship to member countries during a period of exchange stringency?

Reply

The draft proposal provides that the member countries must guarantee the Bank against loss on its holdings of local currencies (III-2). If a member country reduces the value of its currency in terms of gold, it is required to compensate the Bank for the loss by delivering an additional amount of local currency, so that the gold value of the Bank's holdings of local currency after depreciation will be the same as before. A considerable portion of the Bank's capital, from 80 to 90 percent, will be paid in member currencies, and the Bank will acquire additional amounts in the course of its business. To enable it to fulfill its own obligations, the Bank must be protected against the loss which would result from a member's depreciating its currency with respect to gold. On the other hand, in case of the appreciation of a member's currency, the amount by which the value of the Bank's holdings of that currency have increased in terms of gold will be returned to the member country.

Although the Bank is not to be concerned directly with the maintenance of exchange stability, its operations are designed to avoid disturbing established exchange rates. In order to guarantee, participate in, or make a loan in a specified currency, the Bank must secure the consent of the country concerned. This consent may be withheld if in the judgment of the member country the loan would

adversely affect its foreign exchange position (IV-13). Furthermore, the Bank may not buy or sell foreign exchange except with the consent of the countries whose currencies are involved (IV-15-c).

Direct loans by the Bank will be made in the member currencies needed for obtaining the capital goods required, so that as a consequence there should be no great disturbance of the exchanges of either the borrowing country or the capital-supplying country. Payments of interest and principal must be made by the member country in foreign exchange acceptable to the Bank or in gold (IV-10-a,-b). At the time the loan is made the Bank and the borrower may agree to payments in the currency actually borrowed. In either case the Bank is to be protected by the borrower against exchange depreciation (IV-10-d).

While the Bank proposal contains ample safeguards against losses from exchange depreciation, it will permit some flexibility in periods of emergency. It must be recognized that even with the International Monetary Fund and the Bank in operation, some countries may have temporary exchange difficulties. In such cases, the Bank is to be authorized to accept local currency in payment of interest and principal, instead of the required gold or foreign exchange. This privilege is to be extended by the Bank to a borrowing country for short periods (IV-10-c). The borrower is to be allowed a period of several years in which to repurchase this local currency under an agreement that safeguards the value of the Bank's holdings.

As discussed more fully in the answer to Question 19, the position of borrowing and lending countries is safeguarded by the provision that where an indirect need for foreign exchange arises as a result of loans made through or by the Bank, the Bank will provide part of the loan in gold or foreign exchange (IV-8-d; IV-14). By providing exchange for needs arising indirectly from international investment, the Bank will prevent its operations from disturbing exchange rates as much as possible; and member countries will not find their exchange position impaired as a result of the operations of the Bank.

Question 21

Will the rate of interest be uniform on loans guaranteed, participated in, or made by the Bank?

Reply

The rate of interest on loans through the Bank will vary with the conditions of the financial markets and the credit position of the borrower. The basic consideration to be taken into account is that the Bank will not guarantee, participate in, or make loans where the borrower can obtain funds from other sources under reasonable conditions (IV-1, 6). Quite obviously, some governments, municipalities, or business enterprises will be able to borrow in international markets at reasonable rates without the Bank's assistance.

Loans will be made through the Bank only when prospective borrowers are not able to obtain funds on reasonable terms. Since the Bank must be compensated for its risk as guarantor and must also earn a fair return on its direct loans, the rate of interest to borrowers of this type will be higher than that paid in the market by borrowers who do not need the Bank's assistance. In general, the Bank will be concerned merely with making the loan possible and not with equalizing interest rates. The extent of the Bank's guarantee will be just enough to make the securities marketable at reasonable terms.

In the case of Bank-guaranteed loans, interest rates will depend

upon the willingness of the market to absorb the issue. These loans will be secured by the credit of the borrower and by the credit of the Bank as guarantor. The extent of the Bank's guarantee will vary with the conditions of the market and the position of the borrower. Some loans will be fully guaranteed as to principal and interest, others will be only partially guaranteed.

The guarantee of the Bank will undoubtedly reduce the risk on a loan but it cannot completely eliminate it. Even on securities fully guaranteed by the Bank, investors will have to consider the credit of the borrower and evaluate the security partly in terms of the borrower's reputation and financial position. On securities guaranteed by the Bank only in part, the reputation and position of the debtor will be even more important in determining the attitude of investors. The effect of the Bank's guarantee, therefore, will be to reduce the difference between rates of interest paid by various foreign borrowers although differentials will not be eliminated.

Borrowers on guaranteed loans will pay the coupon interest rate to investors and will pay a guarantee fee to the Bank. As stated in the answer to Question 7, this fee may be an annual charge, a fixed amount in a single payment, or a combination of fixed fee and annual charge. The annual cost of a loan to the borrower will be the interest plus the guarantee fee. This cost cannot well be less than the interest rate which will be paid by borrowers who do not need the Bank's assistance.

When the Bank participates in a loan, its position will generally be the same as that of the other participating interests. Its part of the issue will have the same coupon rate and the same terms as the rest. The Bank's participation will influence the interest rate only in so far as it makes possible a larger loan than could otherwise be floated under the given conditions. When the Bank guarantees a loan and also participates in it, the Bank will receive its guarantee fee based on the total amount of the issue. The securities which it holds will be the same as the securities sold to the public and will bear the same interest rate.

There may be instances in which the Bank will participate in a loan without guaranteeing the issue. Subsequently, to dispose of its holdings, it may be necessary to guarantee the issue. The bonds would then be on the market in two forms: guaranteed and unguaranteed. The guaranteed bonds taken from the Bank's portfolio could no doubt be sold at a premium under the assumed conditions, and in this way the Bank could be reimbursed for its risk. When the Bank guarantees and sells securities it holds, there need be no change in the interest rate to the borrower, and no additional guarantee fee.

On loans made directly by the Bank, the interest rate will be related to the rates on loans which it guarantees or in which it participates. Since the Bank is to lend only when the borrower

cannot secure funds at reasonable rates, there would seem to be two types of loans which it might make directly.

The first type of direct loans would be to borrowers of good credit standing who are not able just then to obtain funds from private investors because of financial stringency in world capital markets during a depression period. Their inability to borrow is purely temporary. The Bank can reasonably expect to dispose of such securities as soon as financial conditions improve. The Bank might charge such borrowers interest rates approximately equal to the rates at which the borrowers could secure funds under fairly normal conditions.

The second type of direct loans would be to borrowers who are not able to obtain funds at reasonable rates because of conditions peculiar to them rather than to the financial market. In this case the Bank's interest rates would have to include its own interest cost plus risk premiums which would be roughly equivalent to the amounts which it would receive on guaranteed loans. Probably since these risks are greater than those guaranteed by the Bank, the annual cost to the borrower on such direct loans would be somewhat higher than the total annual cost, interest and fee, on guaranteed loans.

The question of the precise interest rate to be charged on any given loan must be left to the discretion of the governing board. Too many factors are involved to specify in advance all of the conditions which might influence rates, since the state of the financial

markets and the credit position of the borrowers will vary from time to time. Moreover, loans will be made for different purposes and with different conditions. Each of these factors will require evaluation in each specific case. Investing institutions regularly take such factors into consideration, and the Bank's board will have to make decisions of the same character. To a degree, the Bank's policy will be determined by the ability of private investors to make loans and the terms which private investors expect.

The Bank's operations are intended to reduce risks to investors, and this reduction of risks will be reflected in a larger volume of lending and lower interest rates than would prevail in the absence of the Bank. The preference of investors will continue to be reflected in differences in interest rates for various foreign securities.

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Question 22

Will it be possible for the Bank to avoid making loans based chiefly on political considerations?

Reply

The Bank is designed to be an international economic agency to facilitate productive international investment without regard to political considerations. In deciding on loan applications, the Bank is not to be influenced by the political character of the country requesting the credits. This provision is part of the general requirement that the Bank shall scrupulously avoid interference in the political affairs of member countries (IV-19).

The greatest assurance that the operations of the Bank will be based exclusively on economic considerations is given in the provisions of the proposal. The Bank may guarantee, participate in, or make loans only for a specific project or program that has been investigated by a competent committee and has been approved as one that will increase the productivity of the borrowing country and for the servicing of which the prospects are favorable (IV-1-c).

The investigating committee is to consist of experts selected from the technical staff of the Bank and one expert selected by the country applying for the loan. With these requirements, no loan can be made to a country for other than purely economic purposes, and the standards which prospective borrowers must meet are those which protect the economic interests of the lender and borrower.

The character of the Bank's operations should give further assurance that political considerations will not affect the decisions of the Bank. The greater part of the Bank's operations will be directed toward encouraging and facilitating international lending by private investors. While the Bank would generally be prepared to guarantee or participate in loans approved by the technical committees, it would exert no pressure on private investors to undertake such loans. It is reasonable to assume that private investment institutions would not give weight to political factors, except as the stability of the government of the borrowing country affects the risk element in all foreign loans. There is thus a further check by private investors on all loans guaranteed or participated in by the Bank.

The international character of the Bank is also a protection against loans made for political purposes as previously discussed in the answer to Question 15. The Bank itself can have no policy outside the purely financial sphere. So far as concerns individual member countries, they do undoubtedly have important international political interests. However, it would be quite difficult for any member country to utilize the Bank for the purpose of furthering its political interests. Each member country is represented on the Board by one member, and no single country can dominate it (V-1). Furthermore, the Board is expected to consult with the Advisory Council on matters of general policy. The Council is to consist of

men of outstanding ability, whose primary concern would be with economic and financial rather than with political matters (V-5).

It remains true that the possibility always exists that pressure will be exerted to induce the Bank to extend foreign credits because they are politically necessary. So far as possible, the draft proposal is designed to minimize such influences in international lending. We recognize, however, that no set of rules will of itself completely eliminate political considerations and that proper limitation of the Bank's activities depends ultimately on the character of the men responsible for its operations.

This does not imply that international loans for political purposes have no justification. Obviously, there will be instances when loans may properly be made to aid a friendly government. But such loans should not be made with the aid or encouragement of the Bank which is exclusively concerned with international investment for productive purposes, nor should such loans be made with funds provided by private investors. Where loans must be made for political purposes, the funds should be provided by the interested government or governments, without requiring either the Bank or private investors to assume the risks inherent in such loans.