Treasury Department
Division of Monetary Research

Date May 31, 1946

To: Mr. Bernstein

From: Mr. Mikesell

Here is a first draft of the paper which you asked me to write for the Yale Law Review. It needs a lot of work done on it but perhaps the person who is going to publish it can use this as the basis for the article.

If I have time later on I will do some additional work on it but I thought I ought to give you what I have now in case I am unable to do anything further with it.

Attachment

DRAFT:RFM:md
5/10/46

World Fund

THE NEW MONETARY INSTITUTIONS

The economic program of the United Nations is beginning to take shape. The Economic and Social Council has already gotten its teeth into several economic and social policy questions which are enormously important to the peace and general welfare of the peoples of the world. But positive action on specific economic and social problems must come largely from specialized institutions such as the International Labor Organization, the Food and Agriculture Organization, the International Monetary Fund, and the International Bank for Reconstruction and Development. In the field of international trade and financial relations positive action for dealing with continuing problems can only be achieved through institutions with broad authority in specific fields based on international agreements. The inaugural meetings of the Boards of Governors of the International Monetary Fund and the International Bank at Savannah, Georgia last March are important landmarks in the development of a positive international economic program.

The Monetary Fund and the International Bank, together with the proposed International Trade Organization[1] provide a foundation for a United Nations trade and financial program.

1/ Proposals for an International Trade Organization were published by the Department of State, in a pamphlet entitled Proposals for Expansion of World Trade and Employment, Washington, D. C., November 1945. These proposals were agreed to in principle by the British at the time of the negotiations on the British loan last December. They will be the subject of a United Nations conference some time this year.

The Monetary Fund is responsible for the stabilization of international currency values and for the elimination of restrictive and discriminatory currency practices which interfere with transactions across international boundaries. The International Bank has for its province the promotion of foreign capital flows to countries devastated by the war or which lack modern means of production. To round out this international economic program the United States has recently published proposals for an International Trade Organization which would deal with such matters as tariffs and tariff preferences, import quotas, cartels, and international commodity surpluses. Because of the detailed negotiations necessary to work out such an ambitious agreement, it is not expected that the I.T.O. will begin active operations before 1948.

The Fund and Bank came into existence on December 27, 1945 after a sufficient number of countries had approved the agreements drawn up by the representatives of 44 nations at the Bretton Woods conference in July 1944. The Fund and Bank are at once international conventions and autonomous international organizations designed to administer and interpret the agreements which brought them into being. The agreements themselves are unique in the annals of international conventions. This is particularly true of the International Monetary Fund Agreement which contains a number of provisions governing the foreign exchange practices of its members while at the same time giving to the Fund its wide latitude with respect to the conditions under which the fundamental rules on exchange controls will apply. For example, the Fund Agreement stipulates that subject to certain other provisions, members may not impose restrictions on the making of payments and transfers for current international transactions without the approval of the Fund. Nearly every member of the Fund has, at the present time, restrictions of one kind or another contrary to this fundamental rule, but many countries will undoubtedly ask the Fund for permission to retain certain restrictions. Every country which has signed the Agreement, however, has stated that all necessary steps have been taken to enable it to carry out its obligation. This means that every government is bound by international convention to change its ~~laws on~~ exchange control laws whenever they run counter to the Fund Agreement as interpreted by the Fund. Any member has, of course, the alternative of withdrawing from the Fund at any time.

But why ~~xxxxx~~ were countries not required to change their regulations on exchange controls before they signed the basic document? The reason is to be found in the special provisions for the period of transition from a war-time to a peace-time economy. When the Fund's charter was written in July 1944, it was recognized that many countries would be financially unable to accept the fundamental obligations on the use of exchange controls at the time the Fund was inaugurated. In other words, it will be several years before some of the members will be able to balance their international accounts without the use of devices which limit or restrict dealings in foreign currencies. Article XIV of the Fund Agreement dealing with the transitional period provides that members may, notwithstanding other provisions of the Agreement, maintain and adopt to changing circumstances, restrictions on payments and transfers for current international transactions, provided that such restrictions are withdrawn as soon as the member is satisfied that in the absence of such restrictions it will be able to balance its international accounts without undue access to the resources of the Fund.[2]

2/ See Articles of Agreement, International Monetary Fund and International Bank for Reconstruction and Development, U. S. Treasury, Washington, D. C., Article XIV, Sec. 2, p. 29.

Members desiring to take advantage of the transitional arrangements are required to notify the Fund before they become eligible to purchase foreign exchange from the Fund.

The duration of the transition period is not definitely fixed by the Fund Agreement, but five years after the Fund begins operations and each year thereafter, any member still retaining restrictions under Article XIV not otherwise permitted by the Fund must consult the Fund as to their further retention. The Fund can at any time either before or after the elapse of five years request a member to remove any or all of its restrictions otherwise inconsistent with the Agreement. What in effect countries agree to do as members of the Fund, is to change their exchange regulations in accordance with the fundamental rule: under ~~certain~~ conditions which ~~do~~ by their nature involve a considerable measure of judgment on the part of the Fund, and to abide by the decisions of the Fund on the applicability of the Fund's regulations. An agreement of this kind is certainly unique in the history of international conventions. Agreements on foreign exchange and commercial practices have, in the past, generally been limited in scope and specific as to the obligations of each party to the agreement. But in order to deal realistically with present-day international economic problems we cannot rely on ordinary treaties or agreements with perhaps an arrangement for arbitration. We must have a permanent organization with broad powers of interpretation and a large degree of flexibility in the administration of the basic international convention. In recent years our complex domestic problems have required the services of judicial and administrative commissions, fixed laws and ordinary enforcement ppocedures have proved inadequate. The problems which the Fund and the Bank will have to face are even more complex than those of our own Interstate Commerce Commission or the Securities and Exchange Commission.

Important issues for decision by the Fund and Bank will rarely be clear-cut and careful attention must be given to the ability of members to meet the obligations which are imposed upon them. The Fund and Bank will be dealing with sovereign states which are extremely jealous of their powers and which are responsible to their own people for their actions. The Fund must give careful consideration to the effects of its decisions upon the economic welfare of its members and rigid legalisms and strict interpretations of the law will not be tolerated. Unlike the private corporation whose affairs are subject to the jurisdictions of our semi-judicial commissions, members of the Fund and Bank are free to withdraw from the jurisdictions of these institutions at any time.

International economic organizations such as the Bretton Woods institutions and the proposed International Trade Organization must not only have flexibility in dealing with the problems of the immediate post-war period but they must be able to adapt themselves to changing economic conditions over a long period if they are to endure. We do not know what changes will occur in the character of the economies of the world over the next 20 or 30 years. It is not the function of these institutions to determine what kind of internal economic and political organizations their members will have. Rather it is the province of these organizations to secure harmonious economic relations between all nations regardless of the structure of their economies. The development of common international economic policies for ~~of~~ socialistic and capitalistic countries alike is ~~admissable~~ admittedly difficult, but a common ground for international intercourse must be found if we are to avoid economic warfare and to realize the full benefits of international trade. The work of the Fund presents the greatest problems in dealing with countries with different economic structures.

Freedom of exchange transactions and even exchange values themselves have little meaning in a country like the U.S.S.R. where all foreign trade is in the hands of state enterprizes. Nevertheless, certain types of discriminatory financial arrangement forbidden under the terms of the Fund Agreement are applicable to a socialized state. For example, a state trading country may not enter into an arrangement with another country whereby exports to the state trading country are payable in credits which are non-transferable and which are valid only for making purchases within the state trading country. The proposed I.T.O. charter also makes specific provision for members engaging in state trading. For example, members engaging in state trading would be required to agree to accord equality of treatment to all other members and to be guided in their foreign transactions solely by commercial considerations such as price, quality, and other terms of purchase or sale.[3/]

3/ See Proposals for Expansion of World Trade and Employment, p. 17.

Although an important purpose of the Fund is to remove restrictions which governments have placed on individuals transacting business across international boundaries, it is obvious that an international convention cannot give individual business men more freedom in international transactions than they are given by their own governments in domestic transactions. The most that can be hoped for by international agreement is to remove restrictions and interferences which result from the existence of international boundaries alone. Even here the ideal can only be approximated. The Fund, for example, does not ask countries to permit its citizens unlimited freedom to export capital even though these countries may permit unrestricted capital transfers within their own borders. Moreover, under certain conditions, the Fund gives countries permission to limit the foreign currency transactions of their citizens even for current account. These departures from the principle of freedom of exchange transactions are necessary in order to enable countries to safeguard their foreign exchange reserves by controlling their balance-of-payments position. Although the Fund can give countries some assistance in balancing their ~~external~~ international accounts, the primary responsibility must remain with the individual member itself. This will continue to be true so long as nations maintain separate currency systems, and nations will continue to have separate currency systems until they are ready to merge their separate economic systems into one world economy.

The problem of the Bank in adapting its functions and regulations to changing circumstances is less ~~typical~~ difficult than that of the Fund. Most loans will probably be made directly to governments or agents of governments, and all loans must be guaranteed by the government of the territory in which the loan is made. It is expected that except for the 20 percent paid-in capital of the Bank, the bulk of the funds lent directly by the Bank or lent with the Bank's guaranty will be raised in the private capital markets. Before loans can be floated in the markets of a country the Bank must obtain the permission of the government of the lending country. Moreover, there is nothing in the Bank's charter to prohibit governments of the lending countries themselves from purchasing the Bank's debentures or from making direct loans to foreign governments with the Bank's guaranty. It would appear, therefore, that the Bank could operate in a completely socialistic world as well as in a capitalistic ~~world.~~ one.

Although provision is made in the charters of both the Fund and the Bank for amendment by three-fifths of the members having four-fifths of the total voting power (with the exception of certain provisions which cannot be amended) amendment would be difficult in the case of the United States since the Bretton Woods Agreements Act of 1945 specifically prohibits the U.S. representative from accepting any amendment without the approval of Congress. This is not to be regarded as a serious limitation, however. Except for changes in subscriptions, the instruments appear to be sufficiently flexible so as to make unnecessary any amendments which might be required by changing conditions in the structure of world trade and finance.

Administration

Organized as they are under broad charters with a large degree of flexibility and discretion the success of the Fund and Bank will depend in very large measure upon their administration. Final authority on all matters concerning the operations of the Fund and Bank rests with the Boards of Governors of these two institutions. Nearly all countries have appointed one individual to serve as governor of both the Fund and the Bank. At the World Fund and Bank Conference in Savannah last March, the Boards of Governors of these two institutions delegated all powers necessary for the ordinary operations of the Fund and Bank to their respective Executive Directorates. Five of the twelve Executive Directorates of each organization are appointed by the member countries having the largest subscriptions, while the remaining seven are elected by members not entitled to appoint Directors. In addition to the Executive Directors, provision is made in the charters for a Managing Director of the Fund and a President of the Bank.

An important issue at the Savannah Conference was whether the Executive Directors should actively participate in the day-to-day decisions of the Fund and Bank or whether they should meet only infrequently to determine major policy issues. This question was fully decided in favor of full-time Executive Directors actively participating in the current operations of the Fund, a position which was championed by the representatives of the United States. The exact relationship between the Executive Directors who are responsible to the individual country or countries appointing them and the Managing Director and his staff will be determined by experience. This question involves a number of complicated problems which are common to many international institutions. There are some who argue for placing the bulk of the responsibility in the hands of the Chief Executive Officer on the grounds that an international institution can only be managed successfully by an international secretariat without national ties. It is believed that the Executive Directors cannot, by virtue of the nature of their appointments, consider themselves as international servants and work primarily in the interest of the international organization. It is feared that if the Executive Directors play an important role in the current operations and the day-to-day decisions of the Fund and Bank each action will become the subject of endless debate and it will be difficult to develop clearcut operating policies.

If the Fund were simply a lending institution whose general credit policies could be determined by occasional meetings of the Executive Directors, it would certainly not be necessary to have the Executive Directors in continuous session. The fact is, however, that the extension of credits by the Fund is secondary to its main function of developing and administering exchange policies. Within the limits of its charter the Fund through the decisions of its Executive Directors will develop common international monetary policies and will change these policies from time to time in accordance with emerging international economic conditions. An international secretariat simply cannot perform this function. Exchange practices, the alteration of exchange rates, and the making of recommendations to countries for the correction of balance-of-payments difficulties involve national interests and policies important to all members and they cannot be dealt with except by high official representatives who are intimately acquainted with the practices and policies of the countries which they represent. Since it is believed that these problems will be continuing ones it was the view of the United States' representatives at Savannah that the Executive Directors should remain in continuous session.

The International Bank will not deal, except incidentally, with the exchange practices of members, but even here a case can be made for the continual review of the Bank's operations by the Executive Directors. Since the Bank cannot sell its own debentures or guarantee loans except with the permission of the country in which the capital is being raised, it is most important that a representative of the principal creditor country i.e., the United States, participate in the Bank's decisions both with respect to general loan policy and in the making of individual loans. In deciding upon whether or not to permit capital for a particular loan to be raised in this country, the National Advisory Council (which is the agency established by Congress to deal with such matters) will undoubtedly rely very heavily on the advice of the U.S. Executive Director in the Bank. If the American Executive Director did not participate in the preliminary negotiations on a proposed loan, a great deal of time would be lost, and it would be necessary for the National Advisory Council to rely wholly upon its own investigation.

P Although the case is not so clear for continuous representation of members which are not active lenders, each member itself assumes a liability for the repayment of each loan up to the limit of its subscription and hence has an interest in seeing that the loan is sound and in accordance with its general international interest. Moreover, it would be awkward to have an international organization in which only the principal creditor nations maintained actively participating representatives in the Bank. Bank

In concluding this discussion on the functions of the Executive Directors, it should be said that there is every likelihood that the directors will consider themselves to a very large degree as international servants rather than special pleaders for the countries which they represent. Certainly this is true of the United Statates, Great Britain, Canada, and a number of other countries which do not expect to borrow through the Bank or to use the Fund's credits to any substantial degree. Over and above the practical interest of any one of the large or medium-sized countries represented on the Executive Directorates of the Bretton Woods institutions is the success of the enterprises themselves. As they are now constituted, the Executive Directorates of both Fund and Bank give every promise of the highest type of administration.

Relationship to Governments and to the Public

The Fund and Bank are intergovernmental institutions owned and controlled by member governments and their dealings will be primarily with or through member governments, their central banks, or other fiscal agents. At the Savannah conference the U.S. representatives took a firm position on locating the principal offices of both institutions in Washington, D. C. in spite of a strong desire on the part of other members to locate them in New York City, the private, commercial, and banking center of the country. The American stand was made in large part to emphasize the fact that the Fund and Bank are intergovernmental institutions and that they should be completely divorced from private banking influence. There can be little doubt now that the foreign lending capital of the world is not New York but Washington, D. C.

The Fund is organized to deal only with governments, their central banks, and other fiscal agents. It is not a world central bank in that it does not accept deposits nor does it discount bills. Credits are extended by permiting members to buy the foreign currencies they need with their own currency. Each member has a quota which determines the maximum amount of foreign exchange which it can normally purchase from the Fund. Charges are levied by the Fund which vary with the time during which the credits are employed and the amount of the credit in relation to the member's quota. Members are expected to repurchase their own currencies from the Fund with gold or acceptable foreign exchange as soon as they are able to do so. Although the foreign exchange credits made available by the Fund are for the purpose of stabilizing member currencies, the Fund never takes the initiative and does not enter directly into the foreign exchange markets. It sells foreign exchange only to members and upon the latter's initiative.

As is the case with the Fund, the Bank in its role as a lending institution is empowered to deal only through the fiscal agencies of governments. Since the bank will be making loans to private as well as to governmental enterprises, and since it will raise the bulk of its funds from private sources, its relationships with the public will necessarily be much closer than in the case of the Fund. The Bank must depend upon the public for the purchase of its own debentures and ~~those~~ the securities of foreign governments and enterprises which it has guaranteed. It is expected that the bonds issued or guaranteed by the Bank will be purchased by insurance companies, commercial and savings banks, trust funds, institutions, business corporations, investment companies, and individual investors. There are, however, at the present time certain legal barriers to the sale of the Bank's securities to insurance companies and savings banks which must be removed before they can be purchased by these institutions in most states. State laws frequently limit the purchase of securities by savings banks and insurance companies to a list of securities eligible for investment. It is hoped that these laws will be amended in the near future.4/ The New York State Legislature has recently adopted an amendment to its banking laws to permit savings banks to invest in the direct and guaranteed obligations of

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4/ See "The Marketing of World Bank Bonds," by Walter C. Louchheim, Commercial and Financial Chronicle, March 28, 1946; see also "Financing the International Bank," by Henry C. Wallich," Harvard Business Review, Winter 1946, pp. 164-182.

the International Bank.

Since the Bank is empowered to incur liabilities up to $7.7 billion (and up to $10 billion if its membership increases to the maximum authorized capital) it will probably want to develop a wide market for its securities. Because the loans of the Bank will be for the purpose of reconstruction and development they are likely to have fairly long maturities, perhaps 20 to 30 years. The Bank, however, need not be limited to long maturities in its borrowing. In fact, certain classes of investors such as banks will only be interested in purchasing intermediate-term securities of less than 10 years maturity. Since the Bank will continually be receiving amortization payments on outstanding loans it can plan the maturities of its borrowing according to its expected receipts as well as in relation to its needs for funds. As an international institution with very large assets the Bank should have little difficulty in marketing its securities at rates only slightly higher than U.S. Government securities of similar maturity. Interest rates charged by the Bank will be somewhat higher because the Bank is required to exact a fee from borrowers of from 1 percent to 1½ percent. Funds from these charges are put into a special reserve to take care of the Bank's losses.

The Bank will probably not need to rely on underwriting services, especially in the sale of its own debentures. It will presumably need to employ the services of bankers, brokers, and dealers for the distribution of its securities unless it sets up its own distribution medium. In