Copy Sunday June 18

Report of Subcommittee on Government Guarantees and Equity Investments

The Subcommittee considered a recommendation to eliminate altogether condition (a) of Article IV, Section 1, of the draft proposal for the Bank. This is the provision that payment of interest and principal must be fully guaranteed by the national government of the borrowing country. This recommendation was supported on several grounds. First, the history of international investment is replete with examples of ineffective specific guarantees. Second, the guarantees of national governments have on the whole been no less ineffective in assuring payment of service on foreign loans than any other type of guarantee; indeed, obligations guaranteed by national governments have often been among the first of a country's obligations to go into default. Third, the requirement of national government guarantees sets up rigidities in the balances of payments of debtor countries which would, if effective and if circumstances were unfavorable, seriously prejudice the transfer of payments for goods and services and of earnings on non-guaranteed investments.

On deliberation, however, the committee decided to reject this recommendation and propose the following:

1. That from the first paragraph of Article IV, Section 1, there be deleted the words "may guarantee, participate in, or" so that the provision would read "the Bank may make loans to any member country, etc."

To be drafted to require gov't guarantee [illegible]

2. That Article IV, Section 2, of the proposal be amended to read as follows: "The Bank may guarantee or participate in loans made by private investors to a member country, its political subdivisions, and business and industrial enterprises in a member country, under conditions (c) and (d) above, provided the Bank is compensated for its risk in guaranteeing such loans;

3. Delete Article IV, Section 3, of the proposal.

The purpose of these proposed changes in the Bank proposal is to avoid the serious limitation on the use of the Bank's facilities which would almost certainly result, in the opinion of the committee, from a requirement that the specific guarantee of the national government of the borrowing country, central bank, or an equivalent institution be obtained in addition to the multi-government guarantee already provided for. Incidentally the committee felt that this liberalization of the Bank's functions would enhance public support where most needed. It also feels that, if necessary for political reasons, the direct lending functions of the Bank might be subject to additional limitations rather than that the guarantee function be limited as now provided.

It may be expected that public investors, at least in the United States, will be more interested in the guarantee of the Bank than in a guarantee of a national government. It may well be that obligations of political subdivisions and private enterprises will be just as salable without national government's guarantee as with it. On the other hand, if this prediction is unwarranted, the net effect would be that private underwriters would for their own protection and to increase the acceptability of their offerings of their own accord obtain such national guarantees. The provision, therefore, would seem to be of doubtful merit from the point of view of the protection of investors.

From the point of view of the protection of the Bank, there was some question in the committee as to whether national guarantees were in fact substantial or whether too much reliance was being placed upon them. It was felt that the Bank could have recourse to other forms of protection against an over-extension in the guarantee field such as a more rigid delimitation of the ratio of outstanding obligations to its capital and by provision of even more substantial reserves, as well as by increasing its fees on more risky ventures. These forms of protection, however, are always available to the management of the Bank and do not need to be written into the Agreement.

The liberalization of the guarantee and participation features would seem to have another advantage in making the Bank a more effective agency for the stabilization of interest rates and the pricing of foreign issues. This might result from the fact that with this liberalization it may be expected that the Bank would play a more substantial role in the total area of foreign financing, private as well as public, and assist much more effectively in maintaining the flow of international investment funds.

The subcommittee also recommends the following amendment to Section IV, 4, of the proposal to read as follows:

Equity investment by the Bank to be left out because means [illegible]

To promote and facilitate international equity investments the Bank may employ a small part of its capital by participating in such investments, provided (1) that a competent committee, after careful study of the merits of the project, reports that such investment would serve to raise the productivity of the borrowing country, and (2) that the funds are not otherwise available for these purposes on terms which, in the opinion of the Bank, are reasonable.

The primary purpose of this provision is to enable the Bank to facilitate the provision of equity capital by private corporations and financial institutions in addition to the borrowed capital which it can help provide. It may well be that, due to temporary or protracted unfavorable market conditions, foreign enterprises in need of investment capital may be unable to obtain funds without assistance from the Bank. The obtaining of equity capital rather than borrowing is frequently preferred by many sound enterprises and is generally recognized as a desirable trend, not only with respect to domestic financing, but especially in the international field. It may be that United States corporations, for example, would be willing to make investments abroad but that, as with private loans, the terms demanded would be excessively burdensome to the foreign recipient. By the intervention of the Bank and its participation in such ventures, more acceptable and desirable terms could be worked out with advantage to both parties.

Consider also the case of a basic manufacturing enterprise in a capital-poor country which should be financed partly by loans and partly by equity investment. It may be that a majority of the required equity capital can be found within the country but that the enterprise cannot be set on foot unless the remainder of the equity capital, as well as the debt capital, is obtained from foreign sources. In such a case it would seem clear, if the enterprise is desirable from both the national and international points of view, to make the equity capital available through the facilities of the Bank. This encouragement of equity investment would have the further obvious advantage of not burdening the balance of payments of the country with too large an element of fixed service. For this reason and other above indicated, the committee did not consider it desirable to condition the provision of equity capital by a requirement for a government guarantee of conversion into foreign exchange of current earnings of equity investments held by the Bank.