L.B. Rist: Policy Issues of Importance

(2)

October 25, 1947

Confidential

Mr. W. Randolph Burgess
Vice Chairman of the Board
The National City Bank of New York
55 Wall Street
New York, N.Y.

My dear Mr. Burgess,

In accordance with your conversation with Mr. Robert Garner, I am sending you herewith a summary of the Bank's comments on your confidential memorandum of October 14th, 1947 on Financing Aid to Europe.

I should like to emphasize that this summary deals only with the points at which the Bank's staff took issue. It therefore does not fully reflect our wholehearted endorsement of the basic underlying concepts in the paper, i.e. the importance of financial stability and the necessity of providing assistance through grants as well as loans.

Mr. Garner asked me especially to express the Bank's appreciation of your kindness in making this important memorandum available to us for comments.

Yours very sincerely,

Leonard B. Rist,
Director of Research

P.S. - As Mr. Garner told you we intend to see Mr. Bissell as early as possible in the week to go over the matter with him.

Confidential

October 25, 1947

MEMORANDUM

The staff of the International Bank has greatly appreciated the opportunity to review the memorandum on Financingf Aid to Europe. The broad issues which it discusses are vital concern to the Bank, and members of our staff have already devoted considerable study to them. On many of these issues the Bank's thinking closely parallels that expressed in the memorandum, but there are some points on which we should like to comment.

1. The point brought out in the first section of the memorandum - that there exist substantial holdings of gold and dollars in the possession of European nationals, which are now in hiding inside or outside their homeland - is very important and too frequently overlooked. It is valuable also to emphasize the necessity of financial stabilization and reform measures, which would reestablish confidence in the national economies and national currencies, and the futility of simply "supplying more dollars", to be hoarded in their turn". However, the argument as stated in the memorandum seems to imply that sound financial measures can reestablish stability unaided, or that such measures should take priority in point of time over other kinds of action. It was the consensus of the Bank's staff, for example, that the experience of Belgium was not universally applicable; special circumstances helped Belgium's recovery aside from M. Gutt's currency reform (the rapid invasion with little damage to industry, a quiet occupation, large numbers of American liberation troops who left behind ample dollar funds, etc.) In other countries, notably Austria, equally drastic financial measures did not achieve lasting beneficial results and may temporarily have hampered the growth of production.

Nevertheless, currency reforms unquestionably helped to accelerate Belgium's recovery, and we fully agree that financial reforms are necessary elsewhere in Europe as an integral part of the reconstruction program. The emphasis of the Bank's thinking has been on the necessity for a "combined operation", involving the simultaneous use of all the measures required to stimulate production and restore stability - the provision of necessary equipment and supplies under grants or loans, as may be appropriate, and at the same time firm and vigorous application of domestic financial reforms. Certainly any credits which the Bank might make available in connection with the European recovery program would be made conditional on the introduction of effective financial reforms of the kind outlined in the memorandum.

2. As to the latter half of the memorandum, the Bank's staff questioned whether it would be practicable to use the differences in types of goods required as a basis for distinguishing appropriate methods of financing. It was pointed out that the proposed assistance is designed to make up a deficit in Marshall Europe's overall balance of payments, and that it is impossible to find any sound basis for determining what portion of this deficit should be attributed to any particular category of imports. For example, it might be argued that most of Marshall Europe's projected imports of equipment and raw materials will be covered by proceeds of exports and other receipts; that the anticipated deficit arises largely from food, fuel & fertilizer requirements; and thus that all such requirements (estimated at $16.6 billion) should be financed by grants. To base an allocation of funds as between loans & grants on this assumption would be patently incorrect, but any other assumption of this kind would be equally difficult to justify.

Moreover, American aid, and any obligations for repayment which may result, must be allocated not only to Europe as a whole but also among the individual participating countries. They need these different types of goods in differing proportions and they vary widely in ability to pay. Denmark's needs, for instance, are principally for food, fuel & fertilizers, while other countries need mainly equipment or raw materials; yet Denmark may well be in a better position to carry and repay loans than some countries in the other group. Rigid application of the proposed formula would thus be neither equitable to the countries concerned nor realistic in terms of the actual prospects of repayment.

It may be questioned, in any casem whether the distinctions sometimes made among these various types of aid are entirely valid. It is suggested in the memorandum, for example, that an important characteristic of the food, fuel and fertilizers category, as distinguished from raw materials, is that they are not "self-liquidating". But for Denmark fertilizers and feedstuffs are "raw materials" for farm and airy products, jsut as raw cotton is raw material for textiles - exports of eitther type help to provide means for repayment of credits. Another distinction made in the Paris Conference report between mining and agricultural equipment, also seems artificial, and provides a dubious basis for determining the nature of the financial assistance to be applied.

It is implied at various points in the memorandum that separate appropriations for these different types of assistance would be made to, and administered by different adminstrative bodies - for example, that loans for raw materials and short-term projects would be made by the Export-Import Bank, while grants would be handled by some other agency. It was felt by the Bank's staff that the essential unity of the program might be los unless some one agency had final control and disposition of all funds, appropriated for United

States Government aid; an overall policy coordination committeee probably would not suffice for this purpose. This agency might use the Export-Import Bank or other appropriate administrative organs as agents, but should have final control and should be made responsible for the use of all appropriations. One of the most important considerations in this connection is that a single agency would have much more effective influence in enforcing necessary reforms in Europe (financial stabilizations, mobilization of resources, integration of production, liberalization of trade, etc.), as a condition of continuing aid, than if the authority were dissipated among several agencies.

The Bank's staff strongly endorsed the memorandum's conclusion that part of the aid must be given in the form of grants rather than loans and that these two categories must be segregated in some way, The recognition that "more loans would also stand in the way of effective operation of the International Bank" is also greatly appreciated. Despite the arguments mentioned in the preceding paragraphs against determining the appropriate method of financing on the basis of the type of materials supplied, it is recognized that there may be value for the purpose of presenting the program to Congress and the public, in pointing up the necessity for differing types of financing by reference to the differing character of the aid to be supplied.

It would be dangerous, however, to permit this concept to be incorporated into enabling legislation, administrative arrangements or appropriations.

3. The flattering references to the Bank are gratifying, and the Bank's staff had little comment on the general conclusion of that section. It is entirely correct to assume, as is done in the memorandum, that the Bank's ability to make substantial loans to the Marshall Plan countries for equipment will depend on the success of the rest of the Paln, and on whether the recipients of Marshall Plan aid are unduly burdened with obligations to repay dollers.

The present lending capacity of the Bank for Marshall Plqn purposes may, however, be overestimated. Of the United States guarantee of over $3 billion, $500 million has already been lent, and the Bank must consider other customers beside the Marshall Plan countries. Thus, until the equipment requirements as set forth in the Paris report are fully analyzed, it may be questionable whether it is "a fair presumption that the facilities of the International Bank will be adequate," for such requirements.

The suggestions that the Bank's resources might be supplemented in some way by the United States Government to handle this operation have been given some informal consideration by the Bank's staff. Complex policy issues are involved, from the standpoint of both the Bank and the United States Government, but the question certainlu deserves further exploration if it seems best for the Bank to handle this appect of Marshall Plan financing.

4. In connection with raw material loans, the memorandum stresses that "funds for this purpose should not be tied, but should be availabe to spend anywhere and the goods moved in any ships". This is very important; it might even be well to gofarther and recommend that goods in short supply should be b~~r~~ought outisde the United States whenever prices and other factors permit. The same point is valid not only with reference to raw materials, but also for the other categories, notably food, fuel and fertilizers. In the latter connection it is not clear whether the section on food, fuel and fertilizers takes full account of supplies from other than United States sources; the statements on availabilities seem to refer to the United States alone, and might be subject to misinterpreatation.

5. The suggestion that local currency proceeds resulting from the sale of goods supplied through rants should be utilized specifically to further the purposes of the economic reconstruction program has considerable merit. Blocking or limiting the use of these funds would serve an anti inflationary

purposes if it were coupled with the proper budgetm tax and price policies. Thus such action might be an important part of the necessary "combined operation" for financial reform.

In the last paragraphs of the section dealing with raw material credits, however, it is suggested that the proceeds from the sale of these materials be deposited to the credit of the Export-Import Bank for use to purchase strategic materials, and to provide for Embassy & educatinnal expenditures and other purposes of interest to the United States Government. To the extent that the local currencies are releasedm even for investment or for educational or diplomatic expenses, the anti-inflationary effect of their sequestration would be vitiated. As to purchases of strategic materials, it was pointed out that not all European countries produce such materials, and that those which do produce them have already included prospective exports of such materials to the United States in their balance of payments estimates; to the extent that the proposed purchases in local currencies would replace such contemplated exportsm the result would be equivalent to repayment in dollars. Expenditures for diplomatic or educational purposes are a less important factor in the balance of payments, but it may be questioned whether United States needs for such purposes are not amply provided for by the local currency funds already obtained in accordance with the terms of the Fulbright Act.

A question was raised also whether the Export-Import Bank would be the proper agency to undertake the diverse responsibilities of stockpiling, providing educational grants, etc. which are so remote from its present functions.

6. There were a few minor comments on specific points of the memorandum which may be worth enumerating briefly:

a) The figure shown in the graph and tables date from June or July 1947 and thus do not give an entirely accurate picture of the present situation. There has been, for instance, an important depletion of gold and dollar assets in the United Kingdom, Western Europe and Latin America during the past three or four months.

b) In the table on page 7, it is not accurate to say that the United States capital subscription to the Bank is "available" or "Potentially available" for lending.

c) The argument on page 3 that the United States "has always taken the position that foreign money here is under the protection of our laws and traditions as to the sanctity of the peroperty rights of the individual, and we are not likely to change so fundamental a democratic concept" seems to dispose of this problem too lightly. While important practical and ethical questions are certainly involved in any American action to force refugee funds out of hiding, Congress and the American taxpayer may object to the United States footing the total bill while substantial European assets not only escapte being pressed into service for their own countries'reconstruction, but often evade American taxes as well. A further exploration of possible means of making these funds available for constructive usem while at the same time safeguarding the legitimate rights of the owners, should perhaps be undertaken.

d) The statement on page 5 that Americans would be willing to lend or invest money in Europe in the near future, as soon as stability is restored, seems to underrate the possible political uncertainties, fear of war, and other factors which also impair confidence.

e) The Bank's staff feels that to cite Holland, on page 6, as an example of effective financial stabilization is doubtful in view of Holland's serious budgetary difficulties.

f) At the end of the first paragraph on page 11, it is stated that the Bank's resources are "applicable only to the amounts of equipment which must be imported from abroad". This is not entirely true. The Bank can make loans for other purposes and has already advanced credits for raw materials. The same comment applies at the top of page 12. It may also be added that the Articles of Agreement of the Bank do not necessarily preclude loans partly in local currency.

g) The second paragraph on page 12 suggesting that it may soon be possible to finance a substantial amount of raw material movements commercially, seems overoptimistic, since the considerable expansion required must depend on substantial restoration of the European balance of payments equilibrium.

h) With regard to the section on currency stabilization the Bank has no special comment; that is a matter which most directly affects the Monetary Fund. The Bank's staff feels, however, that it would be unwise to minimize the size of the stabilization funds required. The larger and stronger they are the less likely it will be that extensive resort to them will be required.

M.S. Szymczak's letter
Role of the Bank

Pls xerox this
letter & next 4 pages --
i.e., through p. 3 of
the attachment

(205

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

1. Obvious underlying assumpt[n] in our first loans was precisely continuation of capital import in borrowing countries.

2. In case of underdeveloped countries we have not made same assumpt[n]. We assumed total service would have to come from current account.

3. Gl theory = loans never repaid what this means in practice.

4. If ~~Instead of~~ ~~[illegible]~~ we ~~[illegible]~~

Interest represents the profitability of invest[t] - indebtedness is assumed stable.

no 5 | 6

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

~~5 - are we going to rely~~

4. Theoretically Fed is right but practically since our loans have been relatively small, our method of computation has not really been an obstacle - If figures are rising we would have had to face the problem.

Examples Italy & Denmark.

5. The real problem is whether BK is going to accept to
a) what figure will be net $ outflows
b) refund its own maturities
c) increase its overall commitments
~~assume that [illegible]~~
d) is important for ourselves and can be dealt with country by country.

405 (C

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

b) is with reference to the
the aggregate U.S. surplus.

(No 3

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

gone a very long way =

1. We already accepted the fact that self liquidation was not a sufficient test —

2. In several instances we ask for overall invest. programming at least of foreign financed invest. (Colombia)

3. Necessity to determine appropriate invest. possible under several assumptions and alternatives with or without foreign financing - main objection to Currie.

4. Problem in S.A is not whether oil plant is good or bad but assuming it is good. What else is going to be facilitated or sacrificed by its erection

[ho 4]

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

also gone a long way.
presentation slightly differ
but not material difference

SLC/0/223

MAY 31 REC'D

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

M. S. SZYMCZAK
MEMBER OF THE BOARD

- General yes
- however to defer
offer of US loans
payment: longer term
and lower rates

May 29, 1950

Dear Gene:

For some time members of the Board's staff whose work is concentrated in the international field have been studying the general problem of the revival of international investment. In the course of this work, it was inevitable that they should have come to the problem of the role of the International Bank.

I am enclosing herewith, on an entirely informal basis, a memorandum dealing with this problem. It is in no sense an official Board document. You will also understand, I am sure, that neither the authors of the document nor I have any thought of putting the slightest degree of pressure on the Bank's management, through any channel. We have no present intention, for example, of giving the memorandum general circulation within Government circles. My thought was only that you, and possibly others connected with the Bank, might find it interesting to compare the line of thinking indicated in the memorandum with your own thinking on the subject. In some respects the Bank is already in process of formulating policies along lines indicated in the memorandum.

It goes without saying that I should be delighted to arrange for an informal discussion of the ideas put forward in the document, if you feel that such a discussion would serve a useful purpose.

Faithfully yours,

Matt

M. S. Szymczak.

Mr. Eugene Black, President,
International Bank for Reconstruction
and Development,
Washington 25, D. C.

Enclosure.

May 11, 1950
AWM:fsv

The Lending Policies of the International Bank Re-examined

Summary

Page

The Lending Policies of the International Bank Re-examined

1. The IBRD versus its critics

No re-examination of the lending policies of the International Bank for Reconstruction and Development would be fair or in any degree helpful if it did not start by ranging itself on the side of the Bank against most of the Bank's outside critics. It would be idle to deny (and the management of the Bank itself would probably not deny) that the volume of the Bank's lending has been very much below the level hoped for by its more optimistic sponsors. But this is a very different thing from arguing that the Bank has been a total failure. The Bank has been in existence a bare five years. These five years have been years of political, as well as economic, tension in the international field. On the economic side, even in those cases in which countries have begun to formulate development programs, few have been sufficiently free of the problems created by wartime and postwar inflation to be ready to embark on large-scale developmental expenditure. Moreover, for many South American and Asian countries the foreign exchange reserves derived from wartime earnings were sufficient to cover substantial imports of replacement equipment for existing industries, the rehabilitation of which had high priority in the postwar period. Even, moreover, if these economic and political conditions had not existed, it would still have been entirely understandable that the Bank should have proceeded cautiously, feeling its way in terms of procedures and standards.

In re-examining the current lending policies of the IBRD, therefore, the present memorandum has not set itself the purpose of criticising the Bank for having followed these policies in the few short years of its existence. Starting, rather, from the assumption that the present management of the Bank does not regard its present practices and procedures as sacrosanct, it offers suggestions for the modification of those practices and procedures in a direction believed constructive, and of a character consistent with the entirely proper desire of the management to maintain the soundness of the Bank as a financial institution and the credit-standing of its obligations. It may well be, indeed, that some of the recommendations made below are in fact already implicit in operations contemplated by the Bank in the immediate future. In that case, the most that can be claimed for this memorandum is that it will have made clearly explicit what has not in fact been clear even to sympathetic outside observers of the Bank's operations.

2. Summary of recommendations

The argument developed below is designed to support the following recommendations:

a. The "project approach". - The basis for the Bank's loans to particular countries should be, not individual investment projects, but a consistent over-all development program designed to improve the productive and debt-servicing capacity of the borrowing country.

b. Local currency loans. - With respect to local currency loans, if the Bank finds it inexpedient to obtain an explicit modification of Article IV, Section 3, of its Articles of Agreement (which in effect limits the granting of local currency loans to cases in which "exceptional circumstances" exist), it should interpret the reference to "exceptional circumstances" in that Article in such a way as to permit the making of local currency loans whenever the other circumstances surrounding the loan are such as to make the granting of the loan desirable. (The finding of "exceptional circumstances" would then amount to a finding that the substantive objections which might be held to constitute "normal" objections to local currency loans would not apply in the case in question.)

c. Policy with respect to net repayments of principal. - In judging the credit-worthiness of countries as prospective borrowers from the standpoint of the probable ability of the country to service its foreign debt, demonstration of "ability to service" should, wherever necessary, mean primarily a demonstration that the country's balance of payments is likely to show a sufficiently large surplus on current account during the life of the loan to be able to pay interest on the loan in question, rather than, in all cases, interest and amortization.

In all three cases, arguments are presented below to show that acceptance of the proposed recommendation (1) would not impair the soundness of the Bank nor the credit-standing of its obligations;

and (2) would enable the Bank to accomplish with much greater effectiveness the purposes for which the Bank was established.

3. Particular projects or over-all development program?

a. The project approach and sound credit practice. - The principal reason for basing lending decisions on the profitability (in the commercial sense) of the particular projects to be financed is presumably the desire to provide the government of the borrowing country, which (directly or through one of its agencies) must, under Article III, Section IV, (i), guarantee the loan, with some assurance that the borrowed funds will be so invested as to yield a surplus out of which the debt obligation can be serviced.

If this is in fact the basis for the "project approach," one must certainly begin by agreeing that the Bank has been altogether right in its insistence on looking behind the mere fact of a governmental guarantee in order to examine the conditions which will in reality determine whether the loan is likely to be serviced according to schedule. To propose that the Bank should renounce responsibility for undertaking this type of examination would be to ask it to follow credit policies clearly inconsistent with its obligations as a responsible financial agency.

What is questioned here, therefore, is not the Bank's insistence on formulating a judgment as to the economic soundness of the uses to which the borrowing country proposes to put the borrowing funds. What is questioned is rather whether the way to obtain such a judgment is to look at particular projects, one by one, and then to make the loan on the basis of the "profitability" of the particular projects taken in isolation. It is argued here that what the Bank should look at is the "profitability," not of particular projects, one by one, but of a consistent over-all investment program designed to improve the productive and debt-servicing capacity of the borrowing country as a whole.

It will be generally agreed, surely, that it is in fact the "productive and debt-servicing capacity of the borrowing country as a whole" which determines the soundness of the loans made to the country in question. But if this is agreed to, then it is difficult to see why the basis of the Bank's lending to a particular country should not be an inclusive and balanced investment program aimed at the simultaneous development of the various appropriate sectors of the economy, rather than particular projects selected on the grounds of their independent "profitability."

Indeed, it is precisely from the standpoint of the soundness of the Bank's loans that the "project approach" may bring dangers. Whenever a country receives foreign funds, it is put in a position to release its own holdings of foreign funds for other purposes, which may or may not result in improving the "productive and debt-servicing capacity of the borrowing country as a whole." To the extent that the Bank directs its major interest to the profitability of isolated projects, it runs the risk that the net economic effect of its lending may be dissipated by the unwise use of the country's own holdings of foreign exchange. To the extent, on the other hand, that it insists on basing its lending on an over-all judgment of an integrated development program, it acquires an interest in discussing the effect upon its loans of the general investment policy of the borrowing country.

The conclusion, from the foregoing, is not that the Bank should set itself up as a kind of supra-national investment-planning agency, which would exercise a formal veto over all the investment activities of the borrowing countries. What is proposed here would in practice be simply that the Bank, precisely in the interest of providing a greater degree of soundness for its loans, should take the initiative, together with the borrowing country itself, in preparing an inclusive and balanced development program as the basis for its lending, rather than concentrating on an examination of individual projects as they may be submitted one by one. Given acceptance of this principle, there would in fact be no fundamental inconsistency between a policy of examining particular projects and the policy of insisting that these particular projects are to be judged also from the standpoint of their place in the type of inclusive development program indicated here. In this setting, "project loans" could still play a very important (though not necessarily exclusive) role in the Bank's lending program: the approval of successive "projects" as the basis of successive loans would in fact mean the step-by-step realization of the development program. What is essential is that there should in fact exist a development program as a background against which the particular projects can be judged.

b. The project approach and the role of the IBRD. - It is generally agreed that the future lending activity of the Bank must be directed primarily toward development rather than "reconstruction." "Development," in turn, is usually taken to mean primarily development of "underdeveloped" countries. It is precisely in this context that the "project approach" would seem to require reexamination most urgently.

For it is precisely in underdeveloped countries that a general practice of examining projects in isolation is bound to act as a serious brake on expansion of the Bank's lending activities. In an underdeveloped country such as Bolivia, for example, a particular project may not be profitable (in the commercial sense) when considered by itself: i.e., on the assumption that it is the only type of investment to be undertaken. If, however, a group of projects constituting a well-balanced and coordinated developmental scheme were to be financed simultaneously, it might well be that the investment in the total scheme would be economically sound, whereas the investment in any one of the projects treated separately would not be sound. In the former case, the Bank would be entirely justified in undertaking the financing; in the latter case, the Bank would be equally justified, on the basis of the "project approach," in deciding against the financing of the single project for which a loan is requested.

It is, indeed, a simple fact of economic development, even when the development occurs in relatively "developed" countries, that the profitability prospects for investment in an important new line of industry are closely conditioned by what is expected to happen in related fields of investment. Predictions as to the future development of the automobile industry during the 1920's, for example, which took no account of the probable development of road-building during that period, would have been completely in error. In more highly developed countries, with abundant sources of domestic capital available for private financing and adequate possibilities of non-inflationary public financing, it is not unreasonable for lenders to assume that adequate financing will be available for investment projects related to, and necessary for the profitability of, the particular project in which they happen to be interested. The point made here is that this is precisely the kind of assumption that cannot be made in the case of the "underdeveloped" countries whose "development" it was hoped that the Bank would be able to further by large-scale financing. And the further point is made that this would argue for a transference of emphasis by the Bank from an examination of particular projects in isolation to the taking of the initiative in encouraging prospective borrowers to prepare, as the basis for proposed financing, an inclusive and balanced investment program designed to develop simultaneously the various appropriate sectors of the economy.

4. Local currency loans

a. Local currency loans and sound credit practice. - There is no evidence to indicate that, in the past, private international lending, which can be assumed to have considered the risks involved in such lending, evidenced a distrust of, or even a presumption against, the use of a part, or even the whole, of the proceeds of a foreign loan for local currency expenditure, within the borrowing country, on the ground that such loans would involve a greater risk to the lender than would non-local-currency loans. Nor is there any evidence to indicate that this absence of a presumption against international local currency loans on the ground of risk has been correlated, in specific cases, with subsequent losses to the lenders.

Indeed, it is difficult to see why, from the standpoint of the safety of the loan, it should have been otherwise. What matters most to the foreign lender is that the borrowing country should be able to service the loan in foreign exchange of the kinds stipulated for such servicing. Its ability to do so is essentially dependent upon its balance of payments position. And if anything is clear in both the theory and the experience of international payments, it is this: that the most important danger to a country's balance of payments position is the development of inflationary conditions within the country, with a subsequent adverse effect upon its balance of payments and reserve position. Since the principal justification of international local currency loans is that such loans help the borrowing country to avoid the internal inflation and the deterioration of the reserve position that might otherwise result from internal local currency financing, local currency loans, properly administered, could make part of an over-all anti-inflationary program which would actually provide greater assurance to the lender than would a non-local-currency loan granted without regard to the inflationary developments that might result from an attempt to raise all of the required local currency internally.

Attention is invited particularly to the assumption that the international local currency loans will be "properly administered." It is of course possible that the borrowing country, left to its own devices, might take advantage of the relief afforded by an international local currency loan to defer the making of those adjustments in fiscal and credit policy which are required in order to keep total inflationary pressures in check. But this very possibility opens the way to the exercise of pressures by the Bank which could have the effect, not only of protecting the interests of the Bank in the particular loan in question, but also of furthering the avowed aims of the United States in establishing and maintaining full currency convertibility.

It is no rebuttal of this argument to suggest that the borrowing countries will not accept the "infringement of sovereignty" which is implied in the exercise of pressures designed to maintain internal fiscal and monetary stability. The position taken by the United States in the International Monetary Fund with respect to the conditions under which a country may draw on the Fund is evidence enough that we regard as clear, from our standpoint, the right of an international lending agency to insist, as a condition for the making of loans, upon the taking of commitments by the borrowing country with respect to its internal financial policy. Here, indeed, is a field for cooperation between the Bank and the IMF which would bear the closest exploration. The point made here is merely that the possibility of such cooperation will be increased to the extent that the Bank, by contemplating a significant broadening of its activities in the field of local currency financing, is brought more directly in touch with the over-all internal financial situation of the borrowing country. And this means that the soundness of the Bank's investments, instead of being impaired by an extension of local currency financing, could be very greatly increased thereby.

b. Local currency loans and the role of the IBRD. - Local currency loans are not prohibited by the Bank's Articles of Agreement: they are merely (on a literal interpretation of Article IV, Section 3 of those Articles) restricted to "exceptional circumstances." It is for the management of the Bank to decide whether (on the assumption that the argument presented here in favor of extending local currency loans is accepted) it is necessary to amend the Bank's Articles of Agreement by omitting the reference to "exceptional circumstances," or whether it can proceed to extend local currency loans under a procedure which would establish, in each case, that the substantive objections which might be held to be "normal" objections to local currency loans would not apply in the case in question.

What might really be somewhat difficult, in the latter case, would be the formulation of "general" arguments against the granting of local currency loans which would appear reasonable under the circumstances prevailing now and likely to prevail in the immediate future. As far as can be judged, for example, by one who did not participate in the Bretton Woods discussions, the principal idea seems then to have been that imported capital equipment, or, at best, imported supplies and raw materials necessary for the manufacture of capital equipment within the borrowing countries, would always be more urgently needed by the borrowing countries as a whole than foreign exchange which either could provide non-inflationary (or counter-inflationary) financing within the borrowing country, or, by being added to that country's monetary reserves, could permit it to adopt expansionist monetary policies internally which otherwise would entail too great risks to those reserves. The idea seems to have been, further, that, as indicated in Article I, paragraph iv of the Bank's Articles of Agreement, it is the Bank's responsibility to see to it that "the more useful and urgent projects, large and small alike, will be dealt with first"; and that therefore the granting of local currency loans would inevitably have a much lower priority than would loans for the import of capital equipment or of supplies and raw materials necessary for the manufacture of capital equipment within the country.

But this assumption as to the inevitably lower level of "urgency" of local currency loans is <u>only</u> an assumption, rather than a demonstrated proposition. Indeed, at a time when the major emphasis of the Bank's management is rightly being put on the <u>developmental</u> rather than the <u>reconstruction</u> aspect of the Bank's activity, the facts with respect to the relative "urgency" of local currency loans and non-local-currency loans, respectively, are likely, as often as not, to turn out exactly opposite to the assumption under discussion. For most investment activities, the share of imported equipment in the total value of a specific investment is relatively small in any case. This is particularly true, however, if the kind of investment is the sort which is basic to the economy: that which might be called "social overhead"investment. Thus, the building of roads, railroads, canals, and other means of transportation, the construction of electric power installations, the erection of public health, housing, and other basic facilities are types of investment in which the major cost may be for payment for wages and local supplies, with only a small part going for imported equipment. Yet it is precisely this kind of investment which is most crucial for underdeveloped countries, since the "social overhead" investment is frequently necessary before new industrial plants can profitably be put into operation. If, therefore, the Bank is to look at relative urgencies ("priorities") from the standpoint of what must be done <u>first</u> in any program for financing developmental expenditures (because until these "first" things are done, other investment projects will simply not be forthcoming), it can be argued that a sound priority list would give priority precisely to the kind of investment which will inevitably involve a large component of local currency, rather than to the kind involving only, or primarily, expenditure on imported equipment.

It is not suggested here that the Bank management is unaware of this fact. On the contrary, the Bank's position would presumably be, not that it refuses to recognize the necessity for a large local currency component for the projects to which it would like to give priority, but merely that it insists that the borrowing country should itself raise the required local currency from non-inflationary sources. The point made here is merely that, while the Bank should of course continue to insist that the borrowing countries make the maximum effort in this direction, the probable magnitudes involved are of such dimensions as to make it extremely improbable that, even with the greatest possible good-will and energy on the part of the borrowing countries, the sums required can in fact be so raised; that aid, by the Bank, in the direction of providing the foreign exchange equivalent of part of the local currency required could itself be made an instrument of further pressure to secure the further fiscal and monetary action required; and that unless the Bank is prepared to provide this aid, it is virtually inevitable that development programs of the scope required will not in fact be undertaken.

It would be a mistake, moreover, to assume that it is only with respect to "underdeveloped" countries that a case can be made for local currency loans. The concept of a "shortage" of domestic savings, which lies behind the idea of the use of international local currency loans, is entirely a <u>relative</u> concept. A case, indeed, can be made for local currency loans whenever it can be shown that an attempt to raise the amount of local currency required by <u>internal monetary expansion</u> might seriously endanger the balance of payments and the monetary reserve position of the borrowing country. The Belgian proposal and the Italian proposal for the financing of the development program for Southern Italy, which were both largely matters of local currency requirements, are cases in point. A weakening of the balance of payments or reserve position of countries that have otherwise shown gratifying progress toward currency convertibility would not only jeopardize the credit standing of such loans as the Bank has already made to the countries in question; it would in effect run counter to the purpose of the Bank explicitly stated in Article I, paragraph iii, of the Bank's Articles of Agreement: namely, to promote "the maintenance of equilibrium in balances of payment."

5. <u>Policy with respect to net repayments of principal</u>

a. <u>Repayments of principal and sound credit standards</u>. - It is important that there should be no misunderstanding of the recommendation summarized in paragraph 2c above, with respect to the desirability of defining "ability to service" as meaning, wherever necessary, primarily, "ability to pay interest," rather than, in all cases, "ability to pay interest and principal." This does <u>not</u> mean that there need be any change from the current practice of the Bank with respect either to the maturities of its individual loans or with respect to the amortization provisions included in its individual loan contracts. On the contrary, it is assumed here that the present practice of the Bank in both respects will be continued. The recommendation made here has to do with (1) the particular criteria with respect to credit-worthiness which are to be applied in deciding whether a given country's balance of payments is likely to be such as to enable it to "service" the loan; and (2) the policy of the Bank with respect to what, in economic terms, will amount to refunding operations covering a considerable proportion of the required amortization payments.

No one could expect of the Bank's management that it should be prepared to adopt, in the international field, lending policies which would be regarded as unsound in the domestic field. What is being recommended here to the Bank, however, is something quite different: namely, that it be ready to adopt, with respect to international lending, standards which, when other circumstances are favorable, are regarded as entirely acceptable in the case of domestic finance.

Consider, for example, current lending practice in the United States in connection with railroads and public utilities. Accepted investment standards would insist, quite properly, that such enterprises can be regarded as financially sound only if their current earnings are expected to be sufficient to provide for amortization payments equal to depreciation charges on their physical equipment, as well as for interest on debt and dividends on the investment. But it is not part of accepted practice with respect to domestic investment to insist that the enterprises should be expected to show profits large enough to permit, within a period of (say) twenty years, the retirement of all their bonded indebtedness. On the contrary, regardless of the formal maturities and the amortization provisions characterizing the loan-contracts of our domestic railroads and public utilities, refunding is regarded as a normal part of the financing operation, without any suggestion that the soundness of the loans is thereby jeopardized. Indeed, as is so well illustrated by the early history of our railroad financing, one of the chief elements of unsoundness has come from the attempt to finance on a short-term basis, without prospects of refunding, what should have been regarded, from the outset, as very long-term operations involving a series of refunding operations the necessity for which should have been foreseen.

The argument is, if anything, much clearer in the case of international financing, as the latter problem is likely to present itself within the discernible future. A lending policy can hardly be regarded as sound if, in fact, it is based upon an assumption with respect to the future course of the balances of payments of the world which may be regarded as improbable in the extreme. Yet this is what would be involved in any expectation that the Bank is likely to be able to do a considerable amount of lending in the years ahead on the basis of the assumption under examination here: namely, that the borrowing countries will be able, within fifteen to twenty years, to be able to pay, on balance, the principal as well as the interest on loans made now.

For, unless we can count on agencies other than the IBRD to continue to provide a steady outflow of "unrequited" dollars, lending on this basis would involve an expectation that the

United States will actually have a <u>deficit</u> on trade and current invisibles sufficiently large to permit repayment of capital on all of the loans made in U. S. dollars. This is definitely not a reasonable assumption in the years ahead of us. What its implicit acceptance would mean, therefore, is either that the Bank would be counting on an as yet unassured outward flow of dollars from other agencies to balance the stipulated payments on capital account, or that it would be prepared to see a series of defaults on principal payments whenever the outward flow of dollars ceases.

b. <u>Repayments of principal and the role of the Bank</u>. — It is entirely understandable, therefore, that, confronted by this dilemma, the Bank, in the first experimental years, should have come to choose a third way: namely, that of rigorously restricting its loans to countries whose balance of payments prospects were such as provide a probability of the repayment of principal, as well as of interest, within the next fifteen or twenty years. But this choice cannot be regarded as a definitive choice if the Bank is in fact to perform its hoped-for role in the financial field. It may, indeed, fairly be argued that the Bank's management has interpreted accurately the spirit of its Articles of Agreement in insisting that the "prospects of <u>repayment</u>" of its loans be taken seriously into account. But nothing in the Bank's Articles implies disagreement or disapproval of the principle here advanced: namely, that <u>refunding</u> (in economic effect) of a considerable proportion of the agreed repayments on capital account should be regarded as a normal part of the Bank's activities until such time as there is a clear probability that the United States is likely to have a deficit on trade and current invisibles instead of its present and prospective surplus. In practice, this would mean that the Bank would be prepared to contemplate granting successive loans to a given country in a larger gross amount, over a period of time, than would be granted if the country's balance of payments were expected to be such as to permit full amortization on old loans without the help of these successive additional loans.

Given acceptance of this principle, a continuation of the Bank's current practice with respect to the maturities of its individual loans and the amortization provisions included in its individual loan contracts could not be objected to on general economic grounds. On the contrary, their retention could be argued for precisely on the specific economic ground that they would preserve for the Bank the necessary flexibility in the direction and use of a given outflow of its dollars and, in addition, the ability to regulate the <u>amount</u> of its contribution to the total net outflow of dollars from the United States. The point made here is merely that if, in continuing its present practice with respect to maturities and amortization schedules, the Bank does so in full recognition of the inevitability of a policy of "successive lending" which will amount in effect to acceptance of the necessity for refunding operations on a considerable scale, the Bank will be able at one and the same time to do justice to the realities which will determine the ultimate soundness of its loans and to come closer to providing a flow of international investment in some degree comparable to that hoped for when the Bank was established.

6. Inter-relation of foregoing recommendations

The three major recommendations offered above are in fact very closely inter-connected. It could certainly be argued, for example, that the ~~third~~ first recommendation (transference of emphasis from consideration of particular projects in isolation to consideration of an over-all development program) would, if broadly interpreted, itself include the other two. Thus, the development of "an inclusive and balanced investment program" should certainly include a specification of the means by which it is proposed to finance such a program; and this would at once raise the question of the role of local currency financing, and therefore the possible role of the Bank in providing the foreign exchange equivalent of a part of such financing. Similarly, the development of "an inclusive and balanced investment program" should certainly include a specification of the desirable timing of the successive steps in the execution of the program; and this would open the way to recognition, wherever necessary, of the presumption that the Bank would contemplate a program of successive loans in amounts which would, in economic effect, amount to a refunding of a given amount of the amortization payments scheduled on the earlier loans.

The three recommendations are inter-connected, moreover, in another sense: namely, that a broadening of the Bank's policy in each of the three respects indicated will be found to depend upon, and would facilitate, a broadening in the other respects. Thus, if we are dealing with a poor country, lacking enough savings to finance very many or very large projects, it would hardly be possible to demonstrate that the financing only of the imported capital-goods part of a particular project judged in isolation would be either feasible from the standpoint of total financing requirements (because of local currency limitations), profitable as a project (because of the need for complementary investments), or likely to improve the borrowing country's balance of payments position sufficiently to warrant the expectation that principal, as well as interest, would be repaid in, say, twenty years. If, however, external aid were to be made available to finance part of the local currency costs, as well as the requirements for imported equipment, of a broad development program to be executed over a period of years, the total increase in output and national income of the country might well be great enough to improve the balance of payments position of the borrowing country to such an extent that it could expect, with the help of the successive loans made in furtherance of the later parts of the development program, to bear with relative ease servicing requirements considerably larger in the aggregate than would have been required (and have been found unbearable) in the case first presented. In this sense, a policy framework of the kind outlined here would not only have an inherent logical consistency, but should do much to enable the Bank to enlarge the scale of its lending operations on a basis which should in no way impair the credit standing of the Bank itself.

Letter to TRYGVIE LIE

United Nations | Nations Unies

ECONOMIC AND SOCIAL COUNCIL | CONSEIL ECONOMIQUE ET SOCIAL

UNRESTRICTED
E/CN.1/50
6 April 1948
ORIGINAL: ENGLISH

ECONOMIC AND EMPLOYMENT COMMISSION

THIRD SESSION

MEMORANDUM ON THE REPORT OF THE FIRST SESSION OF THE SUB-COMMISSION ON ECONOMIC DEVELOPMENT (DOCUMENT E/CN.1/47) SUBMITTED BY THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

(Item 8 of the Provisional Agenda, document E/CN.1/48)

The following communication containing comments on the Report of the First Session of the Sub-Commission on Economic Development was received from the International Bank for Reconstruction and Development:

INTERNATIONAL BANK FOR RECONSTRUCTION
AND DEVELOPMENT
Washington 6, D.C.

Office of the President

March 31, 1948

The Honorable
Trygve Lie
Secretary-General
United Nations
Lake Success, New York

Dear Mr. Lie:

I am enclosing herewith a memorandum dated March 31 prepared by the staff of the International Bank, and approved by the Bank's Executive Directors, containing certain comments on the Report of the First Session of the Sub-Commission on Economic Development of the United Nations Economic and Employment Commission.

I am sending this memorandum to you at this time so that it may be considered by the Economic and Employment Commission at its next session in conjunction with its consideration of the Report of the Economic Development Sub-Commission.

Sincerely yours,
(signed) John J. McCloy

Enclosure

/INTERNATIONAL

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

STAFF MEMORANDUM

31 March 1948

Analysis of Report of First Session of United Nations Sub-Commission on Economic Development

The staff of the Bank has carefully reviewed the Report prepared by the Sub-Commission on Economic Development of the United Nations Economic and Employment Commission, covering the Sub-Commission's First Session from 17 November to 16 December 1947. This Report requires serious consideration, because it constitutes the first comprehensive statement by an organ of the United Nations on the subject of economic development and will therefore doubtless have considerable influence on the future work of national governments and international agencies in this field.

The Bank's policy on the financing of economic development must, it is believed, be based on the assumption that the primary purpose of such development is to promote an increase in real income per capita, primarily within the country in question. The same concept of the objective of economic development is implied in the Sub-Commission's definition, contained in Part V, paragraph 2 of the Report. In outlining the principles which, in the Sub-Commission's view, will best promote this objective, the Report brings out a number of significant and valuable points. But it also includes some general statements which do not seem fully consistent with the Sub-Commission's initial formulation of its purpose, or which for other reasons appear to need some clarification. It may therefore prove useful to set forth certain views of the Bank's staff on some of the principal matters discussed in the Report, for consideration in conjunction with the Report.

A. The Pattern of Development

An increase in production, which will lead to the desired rise in real income per capita, depends basically upon the introduction of capital goods (tools, housing, transportation and communication facilities, etc.) in so-called "backward" areas. This increase in capital normally involves also an improvement in production techniques, resulting from more efficient organization and management of the production processes and better training of workers, as well as from the substitution of more mechanized for manual methods. The basic problems of economic development are those involved in obtaining capital and assuring its application in a way which will best contribute to increasing productivity and living standards.

/The application

The application of capital in under-developed areas may take place in many different forms - as shown by the varying patterns of historical development in different areas and countries. Thus development may involve principally the mechanization of agriculture and improvement of agricultural land through irrigation or fertilization, or the application of modern extractive methods in mining, or the use of more efficient processing methods for agricultural and mineral products, or the growth of light consumer goods industries, or the establishment of so-called heavy industries, or many other types of capitalization. Normally a major part of development capital will have to be devoted in any case to providing such basic facilities as housing, transportation, communications and power, but the exact nature and location of these facilities will vary widely according to the type of development that is undertaken.

All these forms of capitalization are comprised in the term "industrialization" in its broadest meaning. The more highly industrialized any country is, in the sense of the most effective equipment of labour with capital, the higher will be its standard of living and the greater its productivity. But this is true only if the industrialization proceeds along economic lines, which means that the type of development and its timing must be determined in the light of the natural resources of the country under development, the density of its population and their level of education or technical training, the world demand for the portion of its products which that country intends to export, the availability and cost of the necessary capital, etc.

In the case of some countries the most effective means of development may be the industrialization of agriculture and related activities - i.e. the production of agricultural tools and equipment, the processing of agricultural products, the necessary public utilities, etc. This is the pattern of development which has given New Zealand, for example, one of the highest standards of living in the world; Denmark is another case in point.

In other countries, notably those with excess rural population, with mostly unskilled labour and without resources peculiarly adapted to heavy industry, primary emphasis should normally be placed in the first instance upon the development of light consumer goods industries.* Such industries, by definition, employ small amounts of specialized capital

* The distinction between light and heavy industries, as used in this memorandum, is based on the amount of capital employed per head of worker. For example, many consumer goods and engineering industries are light, while smelting, steel mill, and also some food processing industries, are heavy, within the meaning of those words as here used.

/equipment

equipment per worker and usually contribute more than heavy industry to an immediate rise in the standard of living. They can build upon traditional craft skills in the introduction of mechanized techniques. The capital investment required for the mechanization of many consumption goods industries is not necessarily large - once the necessary transportation, power and other basic facilities are provided - and may often be within the reach of local initiative. The short-run result of this type of industrial development, therefore, is a relatively quick increase in simple consumption goods; this tends further to stimulate development by increasing the health and efficiency of the consumer population and by providing them with incentives for further productive effort. Given reasonably adequate public utilities, the scale of useful capital investment in light industries can be relatively continuous, requiring no very large single investment for a further increase of output.

In many cases, the development of heavy manufacturing industries may have to be delayed until after progress has been made in building up the simpler and more immediately productive light industries. This principle is, of course, subject to many individual exceptions, particularly where the existence of the requisite natural resources and the world demand situation indicate the advisability of proceeding promptly with the establishment of some particular heavy industry. Since, however, in most cases the capital required for investment in basic industries and public utilities which employ large amounts of capital per head of worker and are not directly remunerative may amount to as much as two-thirds of the total investment, it is important to allot the remaining third in such a way that the maximum number of workers can be profitably employed; this argues against the diversion of even more capital from light to heavy industry. One worker employed, for example, in smelting in an over-populated area may require as much capital as ten or more workers in light industries, or to put it in other terms, the cost of his employment may be the total or disguised unemployment of ten other workers. And finally, since the products of heavy industry are frequently not finished consumption goods, its development is relatively less effective in convincing the mass of the people of the advantages to them of further economic development.

Thus economic development must be conceived as a continuous process, in which each increase in capitalization will lead to a further increase. Moreover, it must be synchronized, so that the various aspects of the economy - agriculture, industry and public utilities - will develop

/simultaneously;

simultaneously; otherwise economic disequilibrium will be aggravated. The planning of development should not be confined to national lines, but should be effectively co-ordinated within major geographical areas. It should take account also of possibilities of migration - of moving manpower to resources.

Development, especially of heavy industry, should be so timed as to take account of world prices and other economic conditions. Deliberate anti-cyclical timing of heavy international investment is of great benefit to both capital-importing and capital-exporting countries. At present, the cost of capital equipment is unusually high, because of extraordinary demand and the low output of many normal producing countries. New heavy industries developed now, therefore, might be saddled with an exhorbitant capital cost which would undermine their economic strength and their ability to compete with other producers. Moreover, stimulation of new industries which would not be fully productive for some time to come would tend to aggravate inflationary pressures, both in the country from which the necessary equipment is purchased and, even more seriously, in the country under development. In some cases the urgent need or economic value of a certain type of industry may override these considerations and dictate its immediate development, but the difficulties should be clearly understood so that the merits of each case may be weighed intelligently.

The Sub-Commission's Report, although properly stressing that economic development must be thought of largely in terms of industrialization, does not, in our opinion, sufficiently analyze the nature of the industrialization process as sketched above, and in some places seems to over-simplify the issue by viewing industrialization as synonymous with the development of manufacturing plants, particularly heavy industries.

It is true that the Sub-Commission's emphasis on the development of factory industries is qualified in some degree by its recognition of "the need for due attention to the development of agriculture, particularly the production of food, in national development programmes". However, the general tenor of the Report might create the impression that the Sub-Commission was of the view that agriculture and the production of raw materials should be assigned a place subordinate to manufacturing. Yet it is precisely foodstuffs and certain basic raw materials which are now most seriously lacking throughout the world, and the deficiency in food is especially apparent in some of the least developed countries. Many of the most important resources of these products, actual and potential, are located in under-developed areas; it is essential, therefore, to consider in

/each case

each case whether development of such resources or of particular manufacturing projects would produce quicker and surer returns.

This is not to deny that sound economic development in many, if not most, countries will require growth of factory industries at an appropriate rate. Specifically they may be necessary even in largely agricultural countries to create effective demand for agricultural products and at the same time to increase incentives for agricultural production by making available manufactured consumption goods. But it is clear that the rising national income resulting from such development does not originate in factory industry as such. Rather it stems from the more efficient use of labour in all activities which become adequately capitalized. The economic "backwardness" of under-developed countries is due essentially to the fact that they do not have enough housing and equipment (especially public capital), and that they do not use modern types of capital equipment and technical methods, in all phases of production, not simply in manufacturing industries.

The necessity for a more analytical consideration of the concept of "industrialization" is reinforced by the Report's emphasis on

> the need for establishing key industries in the country, <u>even though such industries may not satisfy strictly economic criteria in terms of comparative costs</u>. Recent experience has demonstrated the dependence of political freedom and national security upon the economic independence of the country, particularly with respect to certain basic sectors of the economy. (Part V, paragraph 6 (b)).

If this paragraph is intended to stress the need for considering not only the direct financial return from a single enterprise, but also its contribution to the national and international economy as a whole, in deciding upon its soundness, it is clearly correct. It is subject to possible interpretation, however, as a blanket encouragement to each individual country to strive for a high degree of industrial self-sufficiency - that is, to develope its own steel industry, chemical industry, electrical equipment industry, machine tool industry, etc. - in order to insulate itself against the insecurities of the world market. If such a policy were generally followed the result would be to narrow rather than broaden the world economy, to waste precious capital and technical skills by devoting them to uneconomic enterprises, to forfeit in large measure the technological advantages of mass production and mass markets, and to require the more productive elements of the national economy to subsidize industries which cannot stand on their own feet.

It is recognized, of course, that certain measures of protection against foreign competition may be necessary for a time to allow industries which have good long-run prospects to get firmly established; but that is quite different from a general policy of establishing industries which do not "satisfy strictly economic criteria in terms of comparative costs". It is, of course, desirable to minimize the adverse effects of international economic instability, but not by encouraging the establishment of small inefficient national production units; rather this aim will be best achieved under a system of expanding, not contracting international trade - although the proportion of national income derived from such trade may gradually be falling as the income itself rises, since the bulk of any additional production will normally go into domestic markets. Finally, it is suggested that unless national development plans take adequate account of costs and efficiency, in terms of the "social net product", no very large flow of international development capital can be expected.

B. The Financing of Development

The Sub-Commission recognizes, in Part VI, paragraph 1, "that the finances required for economic development have to come largely from the efforts of the peoples concerned, from the improvement in their national economic structures, and from increasing national productivity"; but its principal stress is laid on the necessity for "a considerable measure of foreign financing.....in promoting economic development". It concludes, in Part VI, paragraph 4, that

> An examination of the main sources of international loans for development indicates that the total volume of available funds is entirely inadequate to the needs of development. If economic development is to progress more rapidly during the next few years, a larger and better regulated flow of foreign funds than is currently available will have to be promoted by and through international agencies working within the framework of the United Nations.

Part VI of the Report, entitled International Action in the Field of Economic Development, is basically a brief outlining the need for increased international financial assistance. Such a brief is valuable, for the need is unquestionably very great. It is not clear, however, to what agency or groups the Sub-Commission is addressing its final recommendation (Part VII, paragraph 3 A (5)) "that immediate international provision be made for those under-developed countries by way of finance, food and equipment" - nor how this recommendation is to be implemented.

/Financing

Financing through International Bank and inter-governmental channels can be especially useful in helping to provide the framework of public utilities and key industries required for sound development, which may require too heavy an initial outlay and may not be directly remunerative enough to attract private investors. But in general, under existing conditions, only private capital can be expected to provide financing in sufficient amounts for really large-scale development. Such capital, too, normally brings with it much-needed technical know-how and managerial skills. It is essential, therefore, that the under-developed countries do all that they can to promote their own development by stimulating local initiative and encouraging the mobilization of local capital for productive purposes, and that they take appropriate measures, consistent with adequate protection of their own interests, to attract foreign private capital. Consideration must also be given by the capital-exporting countries to the possibility of creating new techniques to encourage the flow of capital abroad.

Although foreign capital may play an indispensable role in stimulating development activity and may greatly ease the strains associated with the development process, nevertheless the major contribution to economic development must be made by local finance and initiative. The Sub-Commission properly stresses this fact in several places. It is important, therefore, that the governments of under-developed countries establish an atmosphere and develop financial mechanisms which will encourage the use of local capital to maximum effect. In some cases such capital is not now fully utilized - either because domestically-held funds are hoarded, or held abroad, or used for speculation or other non-productive purposes; or because there is no efficient machinery for channeling these funds into development activity. The methods appropriate to encourage productive investment of this local capital will vary according to differing national circumstances; the Sub-Commission correctly emphasized the desirability of "examination of a country's monetary, banking and fiscal machinery with a view to making it as effective as possible for development purposes". (Part V, paragraph 15 (c)). The creation of an active local capital market may be of great importance in promoting the efficient use of domestic capital and encouraging its continuing flow into development. In some countries the sums involved are quite substantial and their effective use at strategic points in the national economy will often greatly increase the rapidity of development, will reduce the problems associated with

/foreign

foreign financing and will, at the same time, help to attract the necessary foreign assistance.

The various national governments may also be able to help in promoting an increased flow of international development capital by removing, or at least mitigating, deterrents to foreign lending and investment. In some countries, for example, international lending and investment may be discouraged by an unsound domestic financial situation or by discriminatory regulation of foreign capital. In other cases defaults on past loans have impaired the public credit and prevented or delayed the granting of additional assistance; however, the original terms of some of these defaulted obligations are now manifestly too onerous and modifications should be negotiated. Where difficulties of this kind exist, they clearly have an important adverse effect on the availability of foreign capital, on interest rates, on the period of time for which loans are granted, on the conditions attached to such loans, and so on.

Lending countries also have a parallel responsibility to help in creating conditions and mechanisms which will encourage a greater flow of development capital on equitable terms. Certainly it is not to be expected that borrowing and lending methods in the twentieth century will take the same forms as the nineteenth; new forms and new institutions of private investment must be devised. To achieve a maximum flow of development capital on reasonable terms there must be a fair accommodation of the interests of both capital-exporting and capital-importing countries. Under present circumstances no international organization can compel the investment of capital abroad. There must be some inducement, or at least some assurance of security, to attract private funds, or to persuade responsible governments to make advances to foreign countries. Unless the plans and policies of under-developed countries inspire confidence in their economic soundness, such advances would be made only on political grounds and would be subject to the dangers mentioned in that connection by the Sub-Commission.

Moreover, with regard to direct private investment, it is worth noting that the financing of development by equity capital has some positive advantages from the standpoint of the under-developed countries; it permits a flexibility, initiative and efficiency which is often impossible for government organs; it ensures that unsound investments do not burden or impair the public credit; since its returns depend on actual profits it does not, in bad times, impose an inflexible burden on the public treasury or balance of payments of the "borrowing" country; and it often is

/accompanied

accompanied by managerial and technical assistance of a calibre that would be difficult to obtain in any other way. The Sub-Commission's Report notes, in Part V, paragraph 6 (d), the importance of stimulating "the spirit of enterprise - the spirit that, historically, has played so large a role in economic development;" that spirit, under proper regulation in the public interest, can be as beneficial in motivating foreign financing as in domestic business. Finally, there are certain types of development activity which - because of their experimental nature, or the risks involved, or their close affiliation with other fields of private commercial enterprise - are especially suited to the investment of private equity capital.

It is important, of course, to provide for necessary regulation of private enterprises to prevent waste of the resources of the country under development or abuse of the rights of its citizens. On the other hand, such safeguards should not be so restrictive as seriously to inhibit the flow of capital into productive channels. Foreign investors of equity capital must recognize also that withdrawal of earnings in very large amounts may often create serious balance of payments difficulties for the country in which the investment is located and that for this reason, and to promote further development it is desirable that there be substantial reinvestment of such earnings within the country.

It is important, however, that development programmes should not be so formulated or administered as to obstruct the continuance of emergence of an expert surplus, and the use of an appropriate part of this surplus for international debt service and re-payments. The Sub-Commission rightly observes (Part VI, paragraph 15) that, fundamentally, "it is technological advance and the accompanying increase in national productivity which enables a country to carry the burden of its loan charges and also to repay the loan". But it must not be overlooked in the context of international investment that these changes do not of themselves solve subsequent transfer problems in the international balance of payments. Development programmes which include assistance from foreign capital must take this consideration into account.

C. <u>The Role of International Organs</u>

The United Nations and the Specialized Agencies concerned with economic development have a special responsibility, and also an extraordinary opportunity, to give practical assistance to the under-developed countries in making the best possible use of the domestic resources of those countries and of the foreign aid which may be available. These agencies, because of

/their international

their international character, are in a position, when requested by member governments, to analyze objectively the most promising fields for development activity in various countries or regions, to determine which are likely to produce the most immediate and substantial results in the light of local and world requirements and resources. Such analyses could not, of course, take the place of national programmes, but they could help to provide an international perspective which is too often lacking in such programmes.

Some under-developed countries undoubtedly have an exaggerated impression of the amounts of foreign aid they are likely to receive or, indeed, are able to absorb, and a somewhat unrealistic conception of the conditions under which foreign financing will be available. It is important that they be able to obtain practical advice on these questions from objective international sources so that they may be able to make the best possible use of the funds available. They should be encouraged for the immediate future to concentrate on the essential public services which are necessary to any integrated economy - primarily transportation, communication and power facilities in the most promising areas - and, in most cases, on relatively small projects of assured productive value (some of which, at least, could be undertaken with local capital resources), and generally to postpone more expensive heavy industry until a more favourable time. Otherwise a good deal of precious time, money and enthusiasm may be wasted.

The international agencies should be ready to provide expert assistance to under-developed countries, primarily by heldping them to select and procure competent independent experts who can assist them in the preparation of technically sound national development plans and in putting domestic financial systems and policies on a firm basis.

Finally, the international agencies might well undertake an investigation of the obstacles which now hamper the flow of international capital in sufficient amounts, and of measures which might be taken to stimulate the flow. Despite the reluctance of many countries to accept the need for extensive participation by private capital in development, it remains true, as has already been pointed out, that the major part of any external financial assistance which may be available for development in the foreseeable future must come from private sources. The under-developed countries should be able to obtain sound and disinterested advice from the international agencies as to the measures they can take to stimulate the flow of such private capital on reasonable terms and at the same time

/protect

protect their own interests against abuses resulting from irresponsible private activities.

It seems necessary to comment briefly in conclusion on two specific references to the International Bank contained in the Report of the Sub-Commission. In Part VI, paragraph 7, it states: "There are certain dangers involved in having recourse to the International Bank". These "dangers" are not explained and in its present form the statement is clearly objectionable. In the footnote to paragraph 27, Part VI, it is stated that

> The majority of the Sub-Commission felt that the whole question (of the agreement between the Bank and the United Nations) required more thorough examination than has been given to it, with a view to suggesting an eventual revision of the agreement.....

There is no objection, of course, to any member of the United Nations proposing an examination of the agreement between the United Nations and the Bank, but the need for revision of that agreement should certainly not be prejudged.

R-154
(For consideration by the Executive Directors on March 23, 1948)

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

FROM: THE SECRETARY

March 19, 1948.

REPORT OF THE SUB-COMMISSION ON ECONOMIC DEVELOPMENT
OF THE UNITED NATIONS ECONOMIC AND EMPLOYMENT COMMISSION

Under date of January 14, 1948, by Secretary's Memorandum No. 328, the substantive portions of the REPORT OF THE SUB-COMMISSION ON ECONOMIC DEVELOPMENT OF THE UNITED NATIONS ECONOMIC AND EMPLOYMENT COMMISSION (E/CN 1/47, 18 December 1947) were forwarded for information.

The attached Staff Memorandum of comments upon this document will be considered by the Executive Directors at their Meeting on March 23, 1948.

Distribution

Executive Directors and Alternates
President
Vice President
Department Heads
Secretary, International Monetary Fund

Sec 2-167
MBM/B

(For consideration by
the Executive Directors
on March 23, 1948)

STAFF MEMORANDUM

March 15, 1948

Analysis of Report of First Session of U. N. Sub-Commission on Economic Development

The staff of the Bank has carefully reviewed the Report prepared by the Sub-Commission on Economic Development of the United Nations Economic and Employment Commission, covering the Sub-Commission's First Session from November 17 to December 16, 1947. This Report requires serious consideration, because it constitutes the first comprehensive statement by an organ of the United Nations on the subject of economic development and will therefore doubtless have considerable influence on the future work of national governments and international agencies in this field.

The Bank's policy on the financing of economic development must, it is believed, be based on the assumption that the primary purpose of such development is to promote an increase in real income per capita, primarily within the country in question. The same concept of the objective of economic development is implied in the Sub-Commission's definition, contained in Part V, paragraph 2, of the Report. In outlining the principles which, in the Sub-Commission's view, will best promote this objective, the Report brings out a number of significant and valuable points. But it also includes some general statements which do not seem fully consistent with the Sub-Commission's initial formulation of its purpose, or which for other reasons appear to need some clarification. It may therefore prove useful to set forth certain views of the Bank's staff on some of the principal matters discussed in the Report, for consideration in conjunction with the Report.

A. The Pattern of Development

An increase in production, which will lead to the desired rise in real income per capita, depends basically upon the introduction of capital goods (tools, housing, transportation and communication facilities, etc.) in so-called "backward" areas. This increase in capital normally involves also an improvement in production techniques, resulting from more efficient organization and management of the production processes and better training of workers, as well as from the substitution of more mechanized for manual methods. The basic problems of economic development are those involved in obtaining capital and assuring its application in a way which will best contribute to increasing productivity and living standards.

The application of capital in underdeveloped areas may take place in many different forms - as is shown by the varying patterns of historical development in different areas and countries. Thus development may involve principally the mechanization of agriculture and improvement of agricultural land through irrigation or fertilization, or the application of modern extractive methods in mining, or the use of more efficient processing methods for agricultural and mineral products, or the growth of light consumer goods industries, or the establishment of heavy industries, or many other types of capitalization. Normally a major part, two-thirds or more, of development capital will have to be devoted in any case to providing such basic facilities as housing, transportation, communications and power, but the exact nature and location of these facilities will vary widely according to the type of development that is undertaken.

All these forms of capitalization are comprised in the term "industrialization" in its broadest meaning. The more highly industrialized any country is, in the sense of the most effective equipment of labor with capital, the higher will be its standard of living and the greater its productivity. But this is true only if the industrialization proceeds along economic lines, which means that the type of development and its timing must be determined in the light of the natural resources of the country under development, the density of its population and their level of education or technical training, the world demand for the portion of its products which that country intends to export, the availability and cost of the necessary capital, etc.

In the case of some countries the most effective means of development may be the industrialization of agriculture and related activities - i.e. the production of agricultural tools and equipment, the processing of agricultural products, the necessary public utilities, etc. This is the pattern of development which has given New Zealand, for example, one of the highest standards of living in the world; Denmark is another case in point.

In other countries, notably those with excess rural population, with mostly unskilled labor and without resources peculiarly adapted to heavy industry, primary emphasis should normally be placed in the first instance upon the development of light consumer goods industries. Such industries employ small amounts of specialized capital equipment per worker and tend to contribute to an immediate rise in real incomes. They can build upon traditional craft skills in the introduction of mechanized techniques. The capital investment required for the mechanization of light consumption goods industries is not necessarily heavy - once the necessary transportation, power and other basic facilities are provided - and may often be within the reach of local initiative. The short-run result of this type of industrial development, therefore, is a relatively quick increase in simple consumption goods; this tends further to stimulate development by increasing the health and efficiency of the consumer population and by providing them with incentives for further productive effort. Given reasonably adequate public utilities, the scale of useful capital investment in light industries can be relatively continuous, requiring no very large single investment for a further increase of output.

In many cases, the development of heavy manufacturing industries may have to be delayed until after progress has been made in building up the simpler and more immediately productive light industries. This principle is, of course, subject to many individual exceptions, particularly where the existence of the requisite natural resources and the world demand situation indicate the advisability of proceeding promptly with the establishment of some particular heavy industry. But in most cases the heavy manufacturing industries require a large investment in capital equipment in relation to the numbers of workers employed, thus diverting capital from fields which would produce a more rapid rise in living standards or would promote a better rounded national or regional economy. Such industries also demand technical "know-how" of a depth and range not likely to be immediately available in most under-developed countries. And finally, since the products of heavy industry are not usually finished consumption goods, its development does little to convince the mass of the people of the advantages to them of further economic development.

Thus economic development must be conceived as a continuous process, in which each increase in capitalization will lead to a further increase. Moreover, it must be synchronized, so that the various aspects of the economy - agriculture, industry and public utilities - will develop simultaneously; otherwise economic disequilibrium will be aggravated. The planning of development should not be confined to national lines, but should be effectively coordinated within major geographical areas. It should take account also of possibilities of migration - of moving manpower to resources.

Development, especially of heavy industry, should be so timed as to take account of world prices and other economic conditions. Deliberate anti-cyclical timing of heavy international investment is of great benefit to both capital-importing and capital-exporting countries. At present, the cost of capital equipment is unusually high, because of extraordinary demand and the low output of many normal producing countries. New industries developed now, therefore, might be saddled with an exorbitant capital cost which would undermine their economic strength and their ability to compete with other producers. Moreover, stimulation of new industries which would not be fully productive for some time to come would tend to aggravate inflationary pressures, both in the country from which the necessary equipment is purchased and, even more seriously, in the country under development. In some cases the urgent need or economic value of a certain type of industry may override these considerations and dictate its immediate development, but the difficulties should be clearly understood so that the merits of each case may be weighed intelligently.

The Sub-Commission's Report, although properly stressing that economic development must be thought of largely in terms of industrialization, does not, in our opinion, sufficiently analyze the nature of the industrialization process as sketched above, and in some places seems to oversimplify the issue by viewing industrialization as synonymous with the development of manufacturing plants, particularly heavy industries.

It is true that the Sub-Commission's emphasis on the development of factory industries is qualified in some degree by its recognition of "the need for due attention to the development of agriculture, particularly the production of food, in national development programmes." However, the general tenor of the Report might create the impression that the Sub-Commission was of the view that agriculture and the production of raw materials should be assigned a place subordinate to manufacturing Yet it is precisely foodstuffs and certain basic raw materials which are now most seriously lacking throughout the world, and the deficiency in food is especially apparent in some of the least developed countries. Many of the most important resources of these products, actual and potential, are located in underdeveloped areas; it is essential, therefore, to consider in each case whether development of such resources or of particular manufacturing projects would produce quicker and surer returns.

This is not to deny that sound economic development in many, if not most, countries will require growth of factory industries at an appropriate rate. Specifically they may be necessary even in largely agricultural countries to create effective demand for agricultural products and at the same time to increase incentives for agricultural production by making available manufactured consumption goods. But it is clear that the rising national income resulting from such development does not originate in factory industry as such. Rather it stems from the more efficient use of labor in all activities which become adequately capitalized. The economic "backwardness" of underdeveloped countries is due essentially to the fact that they do not have enough housing and equipment (especially public capital), and that they do not use modern types of capital equipment and technical methods, in all phases of production, not simply in manufacturing industries.

The necessity for a more analytical consideration of the concept of "industrialization" is reinforced by the Report's emphasis on

> the need for establishing key industries in the country, <u>even though such industries may not satisfy strictly economic criteria in terms of comparative costs.</u> Recent experience has demonstrated the dependence of political freedom and national security upon the economic independence of the country, particularly with respect to certain basic sectors of the economy. (Part V, paragraph 6 (b)).

If this paragraph is intended to stress the need for considering not only the direct financial return from a single enterprise, but also its contribution to the national and international economy as a whole, in deciding upon its soundness, it is clearly correct. It might be interpreted, however, as a blanket encouragement to each individual country to strive for a high degree of industrial self-sufficiency - that is, to develop its own steel industry, chemical industry, electrical equipment industry, machine tool industry, etc. - in order to insulate itself against the insecurities of the world market. If such a policy were generally followed the result would be to narrow rather than broaden the world economy, to waste precious capital and technical skills by devoting them to uneconomic enterprises, to forfeit in large measure the technological advantages of mass production and mass markets, and to require the more productive elements of the national economy to subsidize industries which cannot stand on their own feet.

It is recognized, of course, that certain measures of protection against foreign competition may be necessary for a time to allow industries which have good long-run prospects to get firmly established; but that is quite different from a general policy of establishing industries which do not "satisfy strictly economic criteria in terms of comparative costs." It is, of course, desirable to minimize the adverse effects of international economic instability, but not by encouraging the establishment of small, inefficient national production units; rather this aim will be best achieved under a system of expanding, not contracting international trade - although the proportion of national income derived from such trade may gradually be falling as the income itself rises, since the bulk of any additional production will normally go into domestic markets. Finally, it is suggested that unless national development plans take adequate account of costs and efficiency, in terms of the "social net product", no very large flow of international development capital can be expected.

B. <u>The Financing of Development</u>

The Sub-Commission recognizes, in Part VI, paragraph 1, "that the finances required for economic development have to come largely from the efforts of the peoples concerned, from the improvement in their national economic structures, and from increasing national productivity"; but its principal stress is laid on the necessity for "a considerable measure of foreign financing . . . in promoting economic development." It concludes, in Part VI, paragraph 4, that

> An examination of the main sources of international loans for development indicates that the total volume of available funds is entirely inadequate to the needs of development. If economic development is to progress more rapidly during the next few years, a larger and better regulated flow of foreign funds than is currently available will have to be promoted by and through international agencies working within the framework of the United Nations.

Part VI of the Report, entitled <u>International Action in the Field of Economic Development</u>, is basically a brief outlining the need for increased international financial assistance. Such a brief is valuable, for the need is unquestionably very great. It is not clear, however, to what agency or groups the Sub-Commission is addressing its final recommendation (Part VII, paragraph 3 A (5)) "that immediate international provision be made for those underdeveloped countries by way of finance, food and equipment" - nor how this recommendation is to be implemented.

Financing through International Bank and intergovernmental channels can be especially useful in helping to provide the framework of public utilities and key industries required for sound development, which may require too heavy an initial outlay and may not be directly remunerative enough to attract private investors. But in general, under existing conditions, only private capital can be expected to provide financing in sufficient amounts for really large-scale development. It is essential, therefore, that the underdeveloped countries do all that they can to promote their own development by stimulating local initiative and encouraging the mobilization of local capital for productive purposes, and that they take appropriate measures, consistent with adequate protection of their own interests, to attract foreign private capital.

Although foreign capital may play an indispensable role in stimulating development activity and may greatly ease the strains associated with the development process, nevertheless the major contribution to economic development must be made by local finance and initiative. The Sub-Commission properly stresses this fact in several places. It is important, therefore, that the governments of underdeveloped countries establish an atmosphere and develop financial mechanisms which will encourage the use of local capital to maximum effect. In some cases such capital is not now fully utilized - either because domestically-held funds are hoarded, or held abroad, or used for speculation or other non-productive purposes; or because there is no efficient machinery for channeling these funds into development activity. The methods appropriate to encourage productive investment of this local capital will vary according to differing national circumstances; the Sub-Commission correctly emphasizes the desirability of "examination of a country's monetary, banking and fiscal machinery with a view to making it as effective as possible for development purposes." (Part V, paragraph 15 (c)). The creation of an active local capital market may be of great importance in promoting the efficient use of domestic capital and encouraging its continuing flow into development. In some countries the sums involved are quite substantial and their effective use at strategic points in the national economy will often greatly increase the rapidity of development, will reduce the problems associated with foreign financing and will, at the same time, help to attract the necessary foreign assistance.

The various national governments may also be able to help in promoting an increased flow of international development capital by removing, or at least mitigating, deterrents to foreign lending and investment. In some countries, for example, international lending and investment may be discouraged by an unsound domestic financial situation or by discriminatory regulation of foreign capital. In other cases defaults on past loans have impaired the public credit and prevented or delayed the granting of additional assistance; however, the original terms of some of these defaulted obligations are now manifestly too onerous and modifications should be negotiated. Where difficulties of this kind exist, they clearly have an important adverse effect on the availability of foreign capital, on interest rates, on the period of time for which loans are granted, on the conditions attached to such loans, and so on.

Lending countries also have a parallel responsibility to help in creating conditions and mechanisms which will encourage a greater flow of development capital on equitable terms. Certainly it is not to be expected that borrowing and lending methods in the twentieth century will take the same forms as the nineteenth. To achieve a maximum flow of development capital on reasonable terms there must be a fair accommodation of the interests of both capital-exporting and capital-importing countries. Under present circumstances no international organization can compel the investment of capital abroad. There must be some inducement, or at least some assurance of security, to attract private funds, or to persuade responsible governments to make advances to foreign countries. Unless the plans and policies of underdeveloped countries inspire confidence in their economic soundness, such advances would be made only on political grounds and would be subject to the dangers mentioned in that connection by the Sub-Commission.

Moreover, with regard to direct private investment, it is worth noting that the financing of development by equity capital has some positive advantages from the standpoint of the underdeveloped countries; it permits a flexibility, initiative and efficiency which is often impossible for government organs; it ensures that unsound investments do not burden or impair the public credit; since its returns depend on actual profits, it does not, in bad times, impose an inflexible burden on the public treasury or balance of payments of the "borrowing" country; and it often is accompanied by managerial and technical assistance of a caliber that would be difficult to obtain in any other way. The Sub-Commission's Report notes, in Part V, paragraph 6 (d), the importance of stimulating "the spirit of enterprise - the spirit that, historically, has played so large a role in economic development;" that spirit, under proper regulation in the public interest, can be as beneficial in motivating foreign financing as in domestic business. Finally, there are certain types of development activity which - because of their experimental nature, or the risks involved, or their close affiliation with other fields of private commercial enterprise - are especially suited to the investment of private equity capital.

It is important, of course, to provide for necessary regulation of private enterprises to prevent waste of the resources of the country under development or abuse of the rights of its citizens. On the other hand, such safeguards should not be so restrictive as seriously to inhibit the flow of capital into productive channels. Foreign investors of equity capital must recognize also that withdrawal of earnings in very large amounts may often create serious balance of payments difficulties for the country in which the investment is located and that for this reason, and to promote further development it is desirable that there be substantial reinvestment of such earnings within the country.

It is important, however, that development programs should not be so formulated or administered as to obstruct the continuance or emergence of an export surplus, and the use of an appropriate part of this surplus for international debt service and repayments. The Sub-Commission rightly observes (Part VI, paragraph 15) that, fundamentally, "it is technological advance and the accompanying increase in national productivity which enables a country to carry the burden of its loan charges and also to repay the loan." But it must not be overlooked in the context of international investment that these changes do not of themselves solve subsequent transfer problems in the international balance of payments. Development programs which include assistance from foreign capital must take this consideration into account.

C. The Role of International Organs

The United Nations and the Specialized Agencies concerned with economic development have a special responsibility, and also an extraordinary opportunity, to give practical assistance to the underdeveloped countries in making the best possible use of the domestic resources of those countries and of the foreign aid which may be available. These agencies, because of their international character, are in a position, when requested by member governments, to analyze objectively the most promising fields for development activity in various countries or regions, to determine which are likely to produce the most immediate and substantial results in the light of local and world requirements and resources. Such analyses could not, of course, take the place of national programs, but they could help to provide an international perspective which is too often lacking in such programs.

Some underdeveloped countries undoubtedly have an exaggerated impression of the amounts of foreign aid they are likely to receive or, indeed, are able to absorb, and a somewhat unrealistic conception of the conditions under which foreign financing will be available. It is important that they be able to obtain practical advice on these questions from objective international sources so that they may be able to make the best possible use of the funds available. They should be encouraged for the immediate future to concentrate in their planning on the essential public services which are necessary to any integrated economy - primarily transportation, communication and power facilities in the most promising areas - and, in most cases, upon relatively small projects of assured productive value (some of which, at least, could be undertaken with local capital resources), and generally to postpone more expensive heavy industry until a more favorable time. Otherwise a good deal of precious time, money and enthusiasm may be wasted.

The international agencies should be ready to provide expert assistance to underdeveloped countries, primarily by helping them to select and procure competent independent experts who can assist them in the preparation of technically sound national development plans and in putting domestic financial systems and policies on a firm basis.

Finally, the international agencies might well undertake an investigation of the obstacles which now hamper the flow of international capital in sufficient amounts, and of measures which might be taken to stimulate the flow. Despite the reluctance of many countries to accept the need for extensive participation by private capital in development, it remains true, as has already been pointed out, that the major part of any external financial assistance which may be available for development in the foreseeable future must come from private sources. The underdeveloped countries should be able to obtain sound and disinterested advice from the international agencies as to the measures they can take to stimulate the flow of such private capital on reasonable terms and at the same time protect their own interests against abuses resulting from irresponsible private activities.

It seems necessary to comment briefly in conclusion on two specific references to the International Bank contained in the Report of the Sub-Commission. In Part VI, paragraph 7, it states: "There are certain dangers involved in having recourse to the International Bank." These "dangers" are not explained and in its present form the statement is clearly objectionable. In the footnote to paragraph 27, Part VI, it is stated that

> The majority of the Sub-Commission felt that the whole question (of the agreement between the Bank and the United Nations) required more thorough examination than has been given to it, with a view to suggesting an eventual revision of the agreement . . ..

There is no objection, of course, to any member of the United Nations proposing a revision of this agreement, but it seems of doubtful propriety for the Sub-Commission to prejudge the need for revision in advance of the proposed "examination" of the question.

REPORT E/CN 1/47

Mur Bory

United Nations — Nations Unies

ECONOMIC AND SOCIAL COUNCIL — CONSEIL ECONOMIQUE ET SOCIAL

UNRESTRICTED

E/CN.1/47
18 December 1947

ORIGINAL: ENGLISH

DECLASSIFIED
Date: 11/20/20 in accordance with World Bank Access to Information Policy, effective 7/1/2010

Circulated.

ECONOMIC AND EMPLOYMENT COMMISSION

SUB-COMMISSION ON ECONOMIC DEVELOPMENT

REPORT

First Session - 17 November to 16 December 1947

/TABLE OF CONTENTS

TABLE OF CONTENTS

SUB-COMMISSION ON ECONOMIC DEVELOPMENT

REPORT OF THE FIRST SESSION

PART I

Introduction

1. The first session of the Sub-Commission on Economic Development was held at Interim Headquarters, Lake Success, New York, from 17 November to 16 December 1947. The Sub-Commission held twenty-six meetings.

2. The following members of the Sub-Commission attended the session:

Mr. Jose Nunez Guimaraes	(Brazil)
Mr. Alexander P. Morozov	(Union of Soviet Socialist Republics)
Mr. V.K.R.V. Rao	(India)
Mr. Beardsley Ruml	(United States of America)
Mr. Emanuel Slechta*	(Czechoslovakia)

3. Two members of the Sub-Commission were unable to attend the session, and their places were taken by the following alternates, appointed by them in accordance with Rule 60 of the Rules of Procedure.

Mr. C. Esiao (for Mr. D. K. Lieu, of China)*

Mr. M. Bravo Jimenez (for Mr. Victor Urquidi, of Mexico)*

4. The following persons participated in the work of the Sub-Commission as representatives of Specialized Agencies:

Mr. E. J. Riches	(International Labour Organization)
Mr. F. R. Bray	(International Labour Organization)
Mr. D. W. Lusher	(Food and Agriculture Organization of the United Nations)
Mr. S. D. Neumark	(Food and Agriculture Organization of the United Nations)
Mr. S. Arnaldo	(United Nations Educational, Scientific and Cultural Organization)
Mr. J. K. Horsefield	(International Monetary Fund)
Mr. J. J. Anjaria	(International Monetary Fund)
Mr. E. Lopez-Herrarte	(International Bank for Reconstruction and Development)

The Interim Commission of the World Health Organization was represented by Mr. G. E. Hill.

* Not present after the 22nd Meeting held on 12 December 1947.

/5. The following

5. The following participated in the work of the Sub-Commission as consultants from Non-Governmental Organizations:

Mr. P. D. Garvan	(American Federation of Labor)
Mr. Joseph Botton	(International Federation of Christian Trade Unions)
Mr. John R. Minter	(International Chamber of Commerce)

6. The Sub-Commission had the pleasure of having with them for the nineteenth and twentieth Meetings Mr. F. L. McDougall, of FAO, who addressed them on the subject of the National FAO Committees.

/PART II

PART II

Officers of the Sub-Commission on Economic Development

The following members of the Sub-Commission were elected unanimously to serve as officers:

Mr. V.K.R.V. Rao	(Chairman)
Mr. Emanuel Slechta	(Vice-Chairman and Rapporteur)

/PART III

PART III

Agenda

1. Sub-Commission adopted the following agenda:
   (i) Election of Officers.
   (ii) Adoption of Agenda.
   (iii) Study of and Recommendations to the Economic and Employment Commission on Action Needed for Promoting Economic Development and Utilization of Resources. (See documents E/255, Part V; E/445, Part V; and Terms of Reference of the Sub-Commission on Economic Development).
   (iv) Other Business.
   (v) Date of next session.
   (vi) Adoption of the Report to the Economic and Employment Commission.
2. Under item (iii), the Sub-Commission discussed the following topics:
   (i) Principles of Development
   (ii) International Action in the Field of Development
      (a) Finance and Investment
      (b) Foreign Exchange, Balance of Payments and Terms of Trade
      (c) Capital Goods and Export Prices
      (d) Technical Assistance
      (e) Technical Education
      (g) Role of United Nations Agencies in promoting international action in the field of development.
   (iii) Short-term Problems
   (iv) Future Work and Research Projects.

PART IV

Terms of Reference and Instructions

1. At its Third Session, the Economic and Social Council under Resolution 1 (III) of 1 October 1946 instructed the Economic and Employment Commission to set up

"A Sub-Commission on Economic Development, to study and advise the Commission on the principles and problems of long-term economic development with particular attention to the inadequately developed parts of the world, having the objectives of:

(i) Promoting the fullest and most effective utilization of natural resources, labour and capital;

(ii) Raising the level of consumption; and,

(iii) Studying the effects of industrialization and changes of a technological order upon the world economic situation."

2. Having defined its general position with regard to economic development and with reference to the above terms of reference of the Sub-Commission, the Economic and Employment Commission transmitted the following instructions to the Sub-Commission (document E/255):

"(i) To inform the Commission as early as possible regarding current and planned studies, field surveys, and provision of technical advice and assistance to Members in the field of economic development both by the Secretariat of the United Nations and by the inter-governmental agencies.

"(ii) To keep under consideration and to make recommendations to the Commission regarding the general planning and co-ordination of the activities mentioned in paragraph (i) above. Particular attention should be given to the participation of the various inter-governmental agencies in these activities and, where appropriate for the United Nations to participate, to the nature of its participation.

"(iii) To commence a study, in co-operation with the other Commissions of the United Nations and the Specialized Agencies concerned, with a view to making recommendations regarding the need for an international code relating to foreign investments which will cover among other things the protection of economic and social interests of the countries in which investments are to be made, as well as the protection of investors, both public and private; and conduct studies into the need for and methods of

/international incorporatic

international incorporation of private business firms, conducting business operations on an international or a world scale.

"(iv) To make recommendations to the Commission relative to:

(a) the organization of international co-operation with respect to scientific, technological and economic research relating to production and development, the conservation of resources, the adoption of improved methods of production and technical processes to stimulate greater productivity, and the implementation of the mutual responsibilities of Members, under relevant international agreements, in relation to the international supply of facilities for economic development including capital funds, capital goods and materials, equipment, advanced technology and trained personnel;

(b) the furnishing of such technical assistance within the resources available, as Members of the United Nations might request, relating to production and development; and to the organization, in co-operation with the governments concerned, of such missions as may be needed to perform this function.

"(v) To make recommendations to the Commission relative to any other matter which the Sub-Commission may feel should be drawn to the attention of this Commission, including any modification of these instructions which it might wish to suggest."

3. The Sub-Commission also noted the other instructions which had been transmitted to it by the Economic and Employment Commission and which had been outlined in the Note prepared by the Secretariat (document E/CN.1/Sub.3/2)

4. Having discussed its terms of reference and the instructions of the Economic and Employment Commission, the Sub-Commission felt the task before it was one of considerable magnitude and that it would not be possible to take up all the points referred to it at its first session.

5. At the same time, the Sub-Commission recognized the importance of having general principles clarified at its first session and, therefore, devoted several of its meetings to the clarification of general principles of economic development (Chapter V), as also of principles concerning international action in the field of development (Chapter VI). The Sub-Commission also recognized the urgency of some of the short-term or immediate problems before the under-developed countries of the world (Chapter VII) and felt that due attention should be paid to them by the Economic and Employment Commission.

6. Near the end of its deliberations, the Sub-Commission reviewed once again its terms of reference and considered that it had touched on many of the points arising from them, as also on many of those arising from the instructions transmitted to it by the Commission. The Sub-Commission felt, however, that some of the topics referred to it could not be effectively discussed until the relevant material, in preparation by the Secretariat, was available. Among these topics were:

(i) Effects of industrialization and changes of a technological order upon the world economic situation.

(ii) Organization of international co-operation with respect to scientific, technological, and economic research relating to production and development, etc. (vide paragraph 4(a) of the Commission's instructions).

(iii) Patterns of industrialization and detailed study of the problems of industrialization.

(iv) Studies of the need for an international code relating to foreign investment, and of the need for and methods of international incorporation of private business firms conducting business operations on an international or a world scale.

7. The Sub-Commission however felt that it had formulated a body of general principles, which would make its work much easier and speedier at its subsequent sessions and would enable it to visualise the problems before it in clearer perspective.

/PART V

PART V

Purposes and Methods of Economic Development

1. The Sub-Commission points out that the expression "under-developed countries" refers only to the economic aspect of a country's development and does not intend any reflection on the cultural status of development of the country in question. In fact, a number of countries which are economically under-developed enjoy a rich cultural heritage and rank high in the community of civilized nations. It would also like to point out that there is no country in the world which can be described as being economically developed in the fullest sense of the term. Even highly industrialized countries have much room for economic development. At the same time it is quite clear that, generally speaking, there are great differences in the degree of economic development of the various countries in the world. Some are well developed, some under-developed, and others have had very little economic development.

2. It might be useful for the Sub-Commission to indicate as clearly as it can what is understood by the expression "economic development". The objective is the promotion of higher standards of living, full employment and conditions of economic and social progress and development in the countries concerned, and the manner for achieving it is a sound, efficient, and fuller utilization of manpower, natural resources, energy, and capital. The emphasis on "soundness" takes into account the importance of conservation of resources, that on "efficiency" brings into prominence the importance of increase in output per unit of economic effort in the connotation of economic development, while the emphasis on "fuller utilization" draws pointed attention to the fact that in many under-developed economies, the current low standard of living is a direct result of the under-utilization of the resources of the country both extensively and intensively.

3. Before proceeding to state the considerations which the Sub-Commission believes should guide economic development, some general observations are called for regarding the factors responsible for retarding economic development in large parts of the world, and on resulting problems of the so-called under-developed economies. Under-developed economies are to be found not only among the non-self-governing territories of the world but also among a number of Member Nations, whose total population accounts for perhaps more than fifty per cent of the total population of the world. There are many reasons for the retardation of economic development in those countries, some peculiar to individual countries, others common to all of them. The social and economic structure of the countries

/concerned,

concerned, government policies, property relationships, climate, natural resources, disease, geographical location and historical and cultural traditions constitute some of the factors that have played an important part in determining the pace of economic development. In the case of non-self-governing territories, political dependence has been a major factor in the retardation of economic development. In the case of many of the Member Nations with under-developed economies, foreign interference, both economic and political, has undoubtedly constituted one of the main obstacles to realization of the full potentialities of their economic resources. The Sub-Commission therefore stresses the importance of political independence and the desirability of eliminating foreign economic and political interference in order to achieve the objective of the economic development of the under-developed economies of the world.

4. It is the view of the Sub-Commission that economic development has to be thought of largely in terms of industrialization. While economic development cannot be treated as identical with industrialization and due importance should be attached to agriculture in national development, it is nevertheless true that industrialization forms the decisive element of economic development. There can be no economic development in the sense of optimum utilization of resources without the use of capital equipment and modern technological methods. The history of modern economic development shows clearly how capital equipment and modern techniques have contributed to increases in production, productivity and standards of living. Not only does industrialization promote a rapid rise in national income, but its influence tends to radiate throughout the economic structure, thus stimulating the development of other sectors of the economy. The connection between economic development and industrialization has been specifically recognized by the various bodies and agencies of the United Nations. The Sub-Commission would underline, therefore, the importance of recognizing the relation between economic development and industrialization and the importance of insuring that industrialization should, therefore, occupy a prominent place in any programme of economic development.

5. The Sub-Commission considered some of the undesirable economic and social phenomena that, in the past, have accompanied the process of industrialization and suggests that countries on the threshold of economic development should examine into the experiences of countries that have already undergone a substantial measure of industrialization and take deliberate steps to see that their programmes of industrialization avoid these drawbacks and create industrial conditions that result in the maintenance of the dignity of human labour, an equitable distribution of the

/product of industry,

product of industry, a raising of real wages, and the promotion of social welfare. In this connection, the Sub-Commission deems it desirable that trade unions should be called upon to play their appropriate role in the solution of the problems of industrialization.

6. Among other considerations which should guide economic development to which the Sub-Commission wishes to draw particular attention, are the following:

(a) The need for a diversified economy. "Diversified economy" in this context means not only the development of as many sectors in the internal economy as possible; it also means a diversification of the export trade in the case of countries dependent upon exports for a substantial portion of their national income. It is the view of the Sub-Commission that a diversified economy not only distributes internal and external risks over a larger field, thereby promoting both national and international stability, but it also leads to a better utilization of the diversified talents of the community and its diversified human and natural resources, and enables the population to lead a fuller and richer life than would otherwise be attainable.

(b) The need for establishing key industries in the country, even though such industries may not satisfy strictly economic criteria in terms of comparative costs. Recent experience has demonstrated the dependence of political freedom and national security upon the economic independence of the country, particularly with respect to certain basic sectors of the economy; and economic development must be related to the maintenance of political independence. In the case of non-self-governing territories, this consideration has a special application in that the progress of these areas toward political freedom, and the maintenance of such freedom when achieved, will turn largely upon the form and content of their economic development.

(c) The need for diversification of technology. Economic progress is so dependent upon technology that every attempt should be made to see that the development that occurs is such as to promote the utmost diversity of technical talent. This is necessary not only for promoting efficiency and industrial progress, but also for ensuring political and economic security.

(d) The need for co-ordinating economic development with the stimulation and strengthening of the incentive behind economic effort. This is particularly necessary in the case of the

/under-developed

under-developed and the least-developed economies because of the immensity of the effort required from their peoples for the achievement of economic development. In this connection, particular attention needs to be paid to factors governing the will to work and the will to serve in the community. It is also necessary to emphasize the importance of creating incentives that will stimulate the spirit of enterprise - the spirit that, historically, has played so large a role in economic development, especially in the realm of invention and introduction of new technologies.

(e) The need for viewing economic development in terms of the country as a whole. In the absence of such a national viewpoint, there is a danger not only of inadequate and slow economic development, but also of development that may be socially wasteful.

(f) The need for international economic co-operation in progressive economic development. The achievement of economic development is a progress which is accompanied by increased international trade and commerce, which in its turn intensifies the scale and importance of international co-operation on mutually beneficial terms. The United Nations Charter enjoins on all members the obligation to achieve international co-operation in solving international problems of an economic character. It is therefore necessary that the economic development of a country should be such as to take note of its relation to world economy and enable economic co-operation with other countries.

(g) The need for due attention to the development of agriculture, particularly the production of food, in national development programmes. The Sub-Commission feels it necessary to draw attention to this task in view of the present grave food shortage and the prospective increase in the world demand for food. The welfare and standards of living of millions of people being dependent upon the promotion of efficiency in agriculture, the Sub-Commission underlines the importance of agricultural development.

7. This by no means exhausts the considerations that should be taken into account in the economic development of the under-developed countries, for each country has its own peculiar requirements and limitations and social and economic conditions; these are bound to influence the nature of economic development. The general considerations outlined above, however, may be of some use in determining the broad foundations upon which economic development should be based in various parts of the world.

8. The achievement of economic development depends upon a number of conditions, some falling within the realm of national action, others within the realm of international action. The international action necessary for promoting economic development and the role of the United Nations agencies in this regard are discussed later in this report. In the concluding portion of this part of the report the Sub-Commission outlines the conditions it considers necessary within the national sphere for the promotion of economic development. The Sub-Commission is aware that its terms of reference do not call for discussion of conditions in specific countries or action which should be taken by specific countries. These are matters which are essentially within the domestic jurisdiction of the national governments concerned and are therefore, under Article 2 paragraph 7 of the United Nations Charter, beyond the jurisdiction of the Sub-Commission. At the same time the Sub-Commission feels that it is justified in drawing attention to certain general considerations relative to economic development in the national sphere.

9. The Sub-Commission is aware that there is a great deal which can be done toward the promotion of economic development by individual citizens of the countries concerned acting in their private capacities. Private enterprise and private initiative have historically played an important part in economic development, and there is still room in large parts of the world for these factors functioning efficiently toward the same end. In some other parts of the world, public initiative and public and state enterprise have played an important part in promoting economic development. While the Sub-Commission does not express any opinion on the merits or demerits of private or public and state enterprise, it feels that economic development on the required scale in the under-developed and least-developed countries is not likely to be secured without a significant part being played by national governments. Modern technology requires capital and technical skill, which call for governmental aid in many cases and in some, even for governmental enterprise. Moreover, under-developed countries are usually confronted with a scarcity of currently available resources for economic development, necessitating their strict husbanding and regulated use, which in turn involves special action by their governments.

10. At the same time the role of government in national economic development cannot be reduced to a formula, universally applicable in space and time to the different countries of the world; nor can it be decided solely or even largely on a priori considerations. In fact, the role that one would assign to the government of a country in its economic development depends not only upon economic but also upon non-economic

/considerations.

considerations. Thus, it would depend upon, inter alia, the traditions of the people, the psychology of its inhabitants, the extent of the need for economy in the utilization of its resources, the importance attached to social purposiveness in its economic development, the nature, type and degree of economic development it has already undergone, and the pattern of further development it proposes to follow.

11. The Sub-Commission has taken note of the part which has already been played in economic development by different national governments and of the part which many of them are intending to play. The fact remains, however, that there are a number of countries where not much has been done by the governments concerned in either initiating or speeding up the pace of their economic development. The Sub-Commission, therefore, felt that it would be in order for it to suggest certain activities by which economic development could be promoted and its continuity assured. In doing so, the Sub-Commission emphasizes that it is not its intention to suggest to countries which already have machinery for economic development the substitution of a different kind of machinery. It also would like to make it clear that these suggested activities do not imply any alteration in the nature or political complexion of the governments concerned. What follows applies only to countries which have not so far undertaken action on the lines suggested therein. What is suggested below is more by the way of illustrating the kind of activities which may be undertaken by national governments in the realm of economic development rather than the prescription of a set of rules or of specific types of machinery.

12. Subject to the remarks made above, the Sub-Commission considers the following as among the possible and desirable fields of government action:

Under Articles 55 and 56 of the Charter, Member Governments of the United Nations have pledged themselves to take joint and separate action in co-operation with the United Nations Organization for the promotion of economic development. This imposes a specific obligation on Member Governments to take or promote national action for economic development. The Sub-Commission considers that such national action could be taken, inter alia, along the following lines:

(i) Creation of a suitable atmosphere for the promotion of economic development.

(ii) Laying the foundations on which a continuing and expanding structure of future development can be based.

(iii) Provision of direct national assistance to development activities undertaken by private agencies.

/(iv) Direct participation

(iv) Direct participation in economic development.

(v) Regulation and distribution of scarce resources which are important for economic development.

13. The Sub-Commission considers that it is an important governmental task to stimulate public interest in economic development, to create public enthusiasm and national support for programmes of development and to provide the machinery for focussing attention on and for dealing with the problems of development. Such machinery should, inter alia, serve to establish effective co-operation with labour organizations in the countries concerned.

14. The Sub-Commission, therefore, considers it useful that Governments of under-developed countries, and especially those of the least-developed countries, should publicly declare their intention to promote the economic and social development of their countries in such a manner as will lead to a rising standard of living of their peoples. An affirmation of this intent would be of help in rousing public enthusiasm and thereby creating the necessary atmosphere for rapid development. This, the Sub-Commission considers, should be followed by the setting up of the necessary machinery for focussing attention on economic development, for formulating the problems of development and for devising ways and means of solving them.

15. The precise form which this machinery should take will of course depend upon local circumstances and it would not be possible for the Sub-Commission to recommend the machinery that would be appropriate, without modifications, for all the different countries. The Sub-Commission would also observe that there is no need to make any recommendations regarding the establishment of machinery for countries which already have adequate programmes of economic development and the administration for the implementation of such programmes. The Sub-Commission does not feel competent to pass any opinion on the results of the working of such machinery and does not make any suggestions for changes in these countries. What it is really concerned about is the fact that there are a number of countries where there is practically no machinery devoted to the task of promoting economic development, and also the fact that in a number of countries there is not sufficient co-ordination of the various agencies engaged in promoting economic development. The Sub-Commission feels, therefore, that the task of promoting economic development would be facilitated in these countries if their governments would set up in the way they find most convenient, some organization or machinery that would serve the purpose, its exact form of course being determined by each country in the light of its own constitution and traditions. Whatever may be the precise form of the machinery that might be set up, the Sub-Commission feels that it is desirable

/that there should

that there should exist some machinery in those countries which would promote, _inter alia_, the following objectives:

(a) Surveys of national resources, natural, human and technological. This would be particularly important in the case of the least-developed countries.

(b) Setting up targets of economic development, with a view to indicating the extent of effort and the resources needed and stimulating national interest.

(c) Examination of a country's monetary, banking and fiscal machinery, with a view to making it as effective as possible for development purposes.

(d) Examination of existing obstacles to economic development, and especially bottlenecks in the fields of transport, power resources, technical skills and finance.

(e) Definition of criteria for appraising economic development in terms of its pace and content.

(f) Co-ordination, evaluation and, if necessary, supervision of projects and plans of development.

16. The Sub-Commission also emphasizes the necessity of a closer liaison between the governments of the under-developed and least-developed countries on the one hand and the United Nations and its Specialized Agencies operating in the field of economic development on the other.

17. The Sub-Commission recognizes that the main responsibility for creating the institutional framework for development and for laying the foundations for such development rests on government in each country, the distribution of this responsibility among the national, provincial and local government organs being in accordance with the constitution and tradition of each country. This includes, _inter alia_, government action to collect and make available information on resources, to undertake development of transport and power resources, to promote fundamental education, to combat illiteracy, to establish educational and technical institutions, to fight disease and to implement measures to promote public health.

/PART VI

PART VI

International Action in the Field of Economic Development

A. Finance and Investment

DOMESTIC FINANCING

1. The Sub-Commission recognizes that national economic development must be based primarily on the development of national resources and on the increased productivity of the economies of the countries concerned. The bulk of the financial resources required for this development has necessarily to come from the countries themselves. It is of course recognized that the under-developed and especially the least-developed countries have a very small margin of savings because of their low income. Nevertheless, the Sub-Commission would emphasize that the finances required for economic development have to come largely from the effort of the peoples concerned, from the improvement in their national economic structures, and from increasing national productivity.

2. While stressing the importance of domestic savings, the Sub-Commission must point out that in the case of many of the under-developed and least-developed countries, a considerable measure of foreign financing will be required for promoting their economic development. Foreign financing is therefore an important factor in promoting economic development.

FORMS OF FOREIGN FINANCING

3. Each form of foreign financing was considered in the light of its relative advantages for promoting industrialization and other productive development and preventing the danger of interference with the political and economic development of the country concerned. The Sub-Commission would also emphasize that foreign financing involves a flow, from external sources, of goods and services needed for economic development; and that without such a flow, foreign financing would not fulfill its purposes. It is particularly necessary to emphasize this in view of the current shortage of equipment and other goods needed for economic development.

4. An examination of the main sources of international loans for development indicates that the total volume of available funds is entirely inadequate to the needs of development. If economic development is to progress more rapidly during the next few years, a larger and better regulated flow of foreign funds than is currently available will have to be promoted by and through international agencies working within the framework of the United Nations.

/INTERNATIONAL BANK

INTERNATIONAL BANK

5. During the course of the discussion, the Sub-Commission was informed that the International Bank for Reconstruction and Development has so far received only a few applications for loans for development; and even then the amount so far requested, by the under-developed and more developed countries taken together is much greater than the amount at present available to the Bank for purposes of lending. It was also noted that so far the Bank had not utilized its power of guaranteeing loans.

6. The Sub-Commission was informed that under the Bank's Articles of Agreement, eighteen per cent of the capital subscribed by each member government is subscribed in its own currency. Loans in terms of those several currencies are contingent upon the existence of demand for them, and are subject to the consent of the several governments concerned. Up to the present time there has been practically no demand for non-dollar currencies, but it is also noted that there appear to be difficulties on the part of the several non-dollar currency governments to make their currencies available for international loans, since such loans might impair their own foreign exchange resources. As a result, all the loans so far granted by the Bank have been in dollars with the exception of part of one, which was in Belgian francs. It is noted that the difficulties being experienced by the non-dollar currency governments have reduced for the time being the amount of funds available for purposes of lending by the Bank below what would have been otherwise the case.

7. There are certain dangers involved in having recourse to the International Bank. In this connection, the Sub-Commission notes with satisfaction the following clause from Article III, Section 5, paragraph (b) of the Articles of Agreement of the International Bank for Reconstruction and Development.

> "The Bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency and without regard to political or other non-economic influences or considerations."

INTERNATIONAL MONETARY FUND

8. The process of economic development of under-developed countries, and especially the process of industrialization, involves enlarged imports of capital goods and frequently diminished exports of primary products. The Sub-Commission was informed that the International Monetary Fund was designed primarily to help a country tide over its temporary balance of

/payments

payments difficulties. The Sub-Commission was also informed that the Fund could make foreign exchange available to cover temporary or short-term deficits which might be found unavoidable in the process of development because of irregularities in the flow of exports and imports; and that while the Fund is not, strictly speaking, a lending agency, the foreign exchange resources available to members through the Fund would enable them not to be influenced excessively in their development programmes by the short-term difficulties in their balance of payments position.

INTER-GOVERNMENTAL LOANS

9. The Sub-Commission recognizes that an important source of foreign financing today is inter-governmental loans. The conditions and considerations underlying inter-governmental loans are appropriately the subject of negotiations between sovereign governments; nevertheless, the Sub-Commission emphasizes that great care should be taken to see that such loans are used solely in the interests of the peoples of the borrowing countries and are not used to obtain political or other advantages for the countries making those loans. The attention of the Sub-Commission was drawn to the dangers that exist in over-borrowing, but it is felt that, as enough material is not available to the Sub-Commission, a detailed study of the subject should be postponed until the next session.

PRIVATE LOANS

10. The Sub-Commission also recognizes that private loans as a source of foreign financing have the advantage that they can be made quickly in relatively small amounts and can be, more easily directed towards specific purposes which it would be difficult for a government or an international agency to consider in terms of its overall policies. The Sub-Commission emphasizes, however, that great care should be taken to see that such loans do not involve political or economic exploitation of the borrowing country. Caution should also be exercised to make sure that no specific element in the lending country achieves undue advantage with respect to the development of the resources of the borrowing country.

DIRECT PRIVATE INVESTMENTS

11. Direct entrepreneurial investments are generally associated with the import of managerial skills, capital equipment and technical assistance. These investments have no government guaranties attached to them in respect of profits, dividends, terms of repayment, etc. and the foreign investor generally bears all or most of the risks of the business. To this extent private investments are beneficial to the countries receiving them.

/12. However, the

12. However, the Sub-Commission has noted that in practice the foreign investor has, as a matter of course, been more concerned with profits than with the scientific conservation and utilization of the resources of the country in which he operates his investment; and this is a danger to which the Sub-Commission calls attention.

13. Furthermore, experience has proved that direct private investments are accompanied by the dangers of harmful economic and political interference, especially in the case of the dependent and the economically weak countries. The Sub-Commission therefore agrees that past experience indicates that in the least-developed countries, private or government loans and credits are preferable and should be encouraged instead of direct private investments in view of the special danger of direct foreign investments interfering in the political and economic affairs of those countries.

14. With regard to both private loans and direct investments, the Sub-Commission agrees that these loans and investments should be used solely in the interests of the peoples of the borrowing countries and should not be used to obtain political or other advantages for the foreign interests making those loans or investments.

OTHER TERMS AND CONDITIONS RELATING TO LOANS

15. Loans for development purposes should be, for the greater part, long-term loans. In many instances this would be dictated by the fact that development programmes would call for long-range projects involving a long construction period and a further, in some cases prolonged, period of operation before yielding results sufficient for the repayment of the loan. Furthermore, even after a project, or projects, have been completed and put into operation, some time would necessarily elapse before it could make its full contribution, directly or indirectly, toward advancing the technological level of the country. Yet it is technological advance and the accompanying increase in national productivity which enables a country to carry the burden of its loan charges and also to repay the loan. In this sense long-term loans would be preferable both from the borrower's and from the creditor's standpoint.

16. The Sub-Commission considered the importance of interest rates on loans extended for development purposes and emphasized that the interest rate should be kept low. It also considered the question of free loans versus tied loans, and is of the opinion that there are definite advantages in free loans directed toward economic development, since they may open a wider market

/for the

for the borrowing country. The Sub-Commission proposes to give these questions further study at its next session.

B. Capital Goods and Export Prices

17. The objective of foreign borrowing is to obtain foreign commodities essential for economic development, primarily capital goods. This purpose will be defeated unless the lending countries assume the special responsibility and take measures to the end that goods are available for export and that they are available at reasonable and fair prices. Borrowing countries have the responsibility of insuring that the proceeds of foreign borrowing are actually used for the purposes of importing the equipment, techniques and goods necessary for promoting economic development.

18. The recent rise in the prices of capital goods and transport services has made the task of economic development particularly difficult in the case of the under-developed and the least-developed countries. The Sub-Commission therefore considers it important that a careful study be made of the prices of capital goods and of the relative trends of such prices and of prices of primary products, so that it may be in a position to make appropriate recommendations concerning this problem.

C. Technical Education

19. The provision of fundamental education - in the first instance, measures for the reduction or elimination of illiteracy - is a basic requisite for a developing programme of technical training.

20. The Sub-Commission notes that in some of the least-developed countries the form of technical training required at the outset is that of the secondary-school type designed to train skilled workers and foremen; in some other countries, where there has been a greater degree of development, the need is for the establishment of engineering schools and institutes of technology.

21. With reference to technical training, the Sub-Commission considers that it should be promoted primarily within countries themselves rather than by way of arrangements for training abroad; when necessary, appropriate arrangements for advanced technical training abroad should continue, even as national institutions develop more fully.

22. The dissemination of literature on technical problems is recognized as an important development activity.

23. With reference to the various forms and grades of technical training and the promotion of technological knowledge, the Sub-Commission is of the opinion that there is considerable need for international aid in the form of

/the provision

the provision of teaching and training personnel, literature and laboratory equipment. In this connection, the Sub-Commission notes the work done by the ILO in respect of vocational training and the work undertaken and planned by UNESCO in the field of elementary education, technical training, and the dissemination of technical literature.

D. Technical Assistance

24. The Sub-Commission recognizes that the provision of technical assistance to under-developed countries is one of the important forms of international action in the field of economic development. In this connection, the Sub-Commission emphasizes that technical and other assistance to any country should be guided by the principle that such assistance should not be used for the purpose of exploitation or of obtaining political and other advantages for countries rendering such assistance. This would be best secured by organizing the assistance under United Nations auspices.

25. The Sub-Commission notes that technical assistance has been provided thus far under the auspices of several Specialized Agencies - ILO, FAO, the International Bank and the International Monetary Fund. Such assistance is, however, necessarily limited to their respective fields and the Sub-Commission intends in a future session to consider possible methods of assistance covering the field of economic development as a whole.

E. Role of the United Nations Agencies in Promoting International Action

26. With respect to co-ordination of international action on the part of the Specialized Agencies, the Sub-Commission regards it as its continuing responsibility under Article 58 of the Charter and in accordance with the Commission's instructions in this field, to keep itself informed about the work of the Specialized Agencies concerned with economic development and to make recommendations to the Commission relating to the work of these Agencies. During its first session, the Sub-Commission gave special attention to the work of the International Bank and the International Monetary Fund and is transmitting the following observations for the attention of the Commission.

27. It is the view of the Sub-Commission that loans for development purposes should not be appraised by the Bank solely on the basis of eventual direct monetary returns from specific projects for which the loans are asked, but rather on the basis of the contribution that each loan will make to the general economy of the borrowing country, and with due regard to the

/ability

ability of the borrowing country to meet the terms of the loan.*

28. In this connection, it is noted that the Bank and the Fund have an important part to play, at the request of member countries, in helping the formation of sound financial institutions which will mobilize savings for productive purposes, particularly in the least-developed and the under-developed countries. As regards the role of the International Monetary Fund in the development of under-developed countries, the Sub-Commission feels that it would be helpful if liberal policies were adopted by the Fund in meeting the needs of such countries.

---

* One member is of the opinion that the agreement concluded between the Bank and the United Nations does not correspond to several articles of the United Nations Charter, specifically, Articles 58, 62, 63 and 64. He feels that the rights of the United Nations organization are in fact nullified by this agreement, since the Bank and the Fund are thereby placed outside the limits of influence of the organization and the principles of co-operation and liaison between the organization and the Specialized Agencies thus violated. Another member is of the view that the United Nations acted wisely and properly in foregoing such powers for making recommendations as are specified in the agreement with the Bank. The majority of the Sub-Commission felt that the whole question required more thorough examination than has been given to it, with a view to suggesting eventual revision of the agreement in such manner as will not adversely affect the technical competence of the Bank, and at the same time will ensure that the action of the Bank leads to the promotion of economic development in under-developed areas.

/PART VII

PART VII

Short-Term Problems

1. The Sub-Commission notes that many of the under-developed countries are at present faced with serious immediate problems. Among the more important of these problems are:

(i) Food shortages.

(ii) Shortages of other consumer goods brought about by the comparative shortage of imported goods and by the internal dislocations caused by the strains of war.

(iii) Inflationary conditions of an acute character.

(iv) Balance of Payments difficulties.

(v) Transportation difficulties

(vi) Difficulties of obtaining domestic or foreign capital, brought about by the destruction and disinvestment arising out of war conditions and other factors.

(vii) High prices of goods imported by the under-developed countries, and especially of machinery and equipment.

2. The Sub-Commission, however, notes that some of the above difficulties will continue in many countries over a number of years, but that even a partial removal of some of them would either greatly accelerate the present development programmes or enable new programmes to be undertaken.

3. The Sub-Commission also agrees that under-developed countries have not so far received international assistance on the scale justified either by the urgency of their problems or by the magnitude of their requirements. The Sub-Commission therefore makes recommendations in the form of the following resolution for consideration by the Economic and Employment Commission:

THE ECONOMIC AND SOCIAL COUNCIL

A. (1) RECOGNIZING that the current economic position of the various under-developed economies is so serious as to prevent them from efficiently embarking on and/or continuing long-range schemes of economic development,

(2) RECOGNIZING that the internal resources are the basis of economic development and that foreign aid can only be considered as a supplementary resource,

(3) RECOGNIZING nevertheless that an effective handling of the short-period problems is not possible without rapid and substantial international loans and credits in the form of both funds and goods,

(4) RECOGNIZING that the quantum of foreign loans and credits

/available

available either through international or national channels is limited, that substantial calls are already being made on these funds by the economically more developed areas of the world, and that there is great danger of the short-term needs of the economically under-developed areas being neglected,

(5) RECOMMENDS that immediate international provisions be made for those under-developed countries by way of finance, food and equipment, in order that they may better deal with their short-term economic problems, and thus facilitate not only the promotion of their own economic development but also the successful rehabilitation of the economies of the more developed parts of the world and the maintenance of world stability and full employment, but that such provision should not be used for the purpose of exploitation or of obtaining political or other advantages for the countries rendering such assistance.

B. (1) RECOGNIZING that it is necessary that immediate international provision be made to assist in meeting the short-period economic problems of the under-developed economies,

(2) RECOGNIZING that it is difficult to ascertain the amount of help necessary without a comprehensive study of the immediate requirements of countries in different economic circumstances, and

(3) RECOGNIZING that it is desirable to have specific data collected about the magnitude and variety of the short-period requirements of those countries,

(4) NOTES WITH SATISFACTION the terms of reference of the Economic Commission for Asia and the Far East, and

(5) RECOMMENDS that similar functions be assigned to other Regional Economic Commissions that may be set up by the United Nations.

C. (1) RECOGNIZING that it is imperative that there should be an early contribution toward the rapid solution of the immediate short-period problems of the under-developed economies, and

(2) RECOGNIZING that it would not be possible to find from international sources all the funds and equipment necessary for the solution,

(3) IS STRONGLY OF THE OPINION THAT the Governments of under-developed countries should proceed to consult with one another and with others, in such manner as they deem fit, on their short-period requirements and on the extent to which these could be met by mutual economic agreements and by better utilization of their national resources.

/PART VIII

PART VIII

Future Work and Research Projects

1. The Sub-Commission is of the opinion that the subjects to be considered by it should in the future be selected far enough in advance to enable members to prepare for the discussion.

2. The economic situation of the under-developed countries, including the Non-Self-Governing territories, and the problem of industrialization are felt to merit specific attention. Certain broad questions of finance also require special study, particularly questions concerning foreign financing and national financial institutions and practices. Transportation problems have become of such urgency as to call for special examination by the Sub-Commission. Reviewing the work of the Specialized Agencies concerned with economic development is, in the opinion of the Sub-Commission, a continuing function, which should be included in the agenda of each session.

3. Some consideration has been given to placing other items on the agenda for the Second Session, among them questions of public health, fuel and power, migration, the motivation of economic development, and the adaptation of technologies to meet the needs of under-developed areas. It is concluded, however, that while these subjects might be brought into the discussion of the Second Session, the agenda as visualized above is already too full to permit of separate discussion of each of these topics.

4. The Sub-Commission is emphatically of the opinion that, in order to function effectively, members should be continuously in contact with the literature pertinent to problems of economic development, especially documentation prepared by the United Nations organization and the Specialized Agencies. It, therefore, recommends to the Economic and Employment Commission that the United Nations organization and its Specialized Agencies be requested to transmit directly to the members of the Sub-Commission documents prepared by them on subjects relating to economic development.

5. The Sub-Commission's work could be considerably expedited by research in appropriate fields. After some discussion, it has been agreed that research in the following four fields would prove particularly helpful to the Sub-Commission:

(1) Foreign Financing

Discussions during the First Session of the Sub-Commission have resulted in a body of general conclusions concerning foreign financing but, before considering the question of a code for international investment, a full discussion of this subject is called for, including

/information

information on what is being done, how it is being done, and who is doing it. In this connection, data on the movement of capital during the inter-war period would be particularly useful. These would include the volume and direction of movement, the terms of investment, and their effects on borrowing countries.

(ii) Banking and Financial Institutions

The problem of mobilizing domestic capital and channeling it to economic development is one of the major problems of development. It is the view of the Sub-Commission that adequate data should be obtained on the nature, scope and functioning of the many domestic institutions through which capital is obtained for economic development

(iii) Industrialization

The Sub-Commission notes that the Secretariat has already been instructed to undertake studies of the patterns of industrialization that have developed under differing economic conditions. The terms of reference of the Sub-Commission call for a study of the effects of industrialization and changes of a technological order upon the world economic situation. It is the feeling of the Sub-Commission that the Secretariat should examine the feasibility of such a study and communicate a preliminary plan to the Sub-Commission before the next session. Members who wish to make suggestions in this connection, even before the preliminary plan of study is drafted, should do so and their suggestions should be forwarded to other members by the Secretariat. The Sub-Commission recognizes that this subject cannot be covered by a single paper, but will require separate papers on several different aspects of industrialization.

(iv) Machinery for Economic Development

It would be useful to make available the experience gathered by the more-developed economies, particularly in respect of the machinery employed by them for promoting their own economic development. This involves considerable research. Some of this research might be carried out by the Secretariat, but contributions should also be made by members of the Sub-Commission on the basis of experience in their own countries.

6. The responsibility for carrying out these and other research studies must fall largely upon the Secretariat. It is the consensus of the Sub-Commission that it would be unwise for it to define too precisely the content of these studies or the way in which they should be carried out. It is also its opinion that the work of the Secretariat would be valuable not only in the compilation, organization and presentation of factual data but also in their analysis of such data.

PART IX

Date of the Second Session

The Sub-Commission agreed that it would be convenient to hold the second session during the first part of June 1948 and requested that the Secretariat take appropriate action.

Annex to N. ARMOUR

CONFIDENTIAL

Secretary's Memorandum No. 373

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

FROM: THE SECRETARY

March 22, 1948

Attached for consideration by the Executive Directors at the meeting on March 23 are:

(a) Letter dated March 12 from Mr. Norman Armour, United States Assistant Secretary of State for Political Affairs, to the President of the Bank;

(b) Suggested reply by the President.

Attention is drawn to the fact that "Annex A" referred to at the end of Paragraph 2 of the suggested reply is not attached hereto, due to limitations of time. This Annex is a factual summary of the loan discussions referred to.

Distribution

Executive Directors and Alternates
President
Vice President
Department Heads

Sec 2-176
MMI/B

COPY

DEPARTMENT OF STATE

Washington

March 12, 1948

My dear Mr. McCloy:

Not long ago you indicated to me your interest and that of the International Bank for Reconstruction and Development in extending long term credits to the other American Republics for development purposes. I believe that you likewise indicated that you would be glad to address a letter to the Department setting forth the Bank's policy along the foregoing line.

A letter from you stating that the Bank's policy is favorable to the extension of long term credits to the other American Republics for economic development would be of great help to us in connection with the forthcoming Bogota Conference. While it is fully recognized that the Bank is an international institution, it is nevertheless true that such a letter from you would be of value to the United States Delegation to the Conference and likewise of great interest to the other American Republics. I should appreciate anything you could do along this line.

With kindest regards, believe me,

Sincerely yours,

/s/ Norman Armour

The Honorable
John J. McCloy,
President, International Bank for
Reconstruction and Development,
1818 H Street, N. W.,
Washington, D. C.

DRAFT

Honorable Norman Armour
Assistant Secretary of State
Washington 25, D. C.

My dear Mr. Armour:

I am writing this letter in response to the request you have made on behalf of the United States Government for an expression of the policy of the International Bank for Reconstruction and Development with respect to granting long-term credits to the other American Republics for development purposes.

One of the two principal objectives for which the International Bank was created was to make sound long-term loans of precisely the type needed for the further economic development of the other American Republics. The Bank is now ready, able and willing to make such loans. It has been conducting discussions with a number of Latin American countries over the past year and a half looking toward the extension of long-term credits for development purposes; the status of all such discussions (except those covering one project which the Bank has been requested to keep confidential) is summarized in a memorandum accompanying this letter, marked Annex A.

I think it is fair to say that the other American Republics constitute at the present time a special sphere of interest to the Bank. The most urgent reconstruction needs of Europe are being met through direct United States Government aid and, although the Bank expects to play a substantial part in promoting the recovery of Europe, it will of necessity, during the period of the European Recovery Program, be a supporting rather than the primary role. In the Middle East and the Far East, the Bank expects, over a period of years, to be able to make a real contribution, but most of the projects under consideration for those areas have not yet reached the stage where they are ready for financing. It is in the Latin American countries that, for the immediate future, I regard the Bank as having perhaps its greatest opportunity to render constructive assistance.

Analysis of the loan requests which have thus far been received from the other American Republics reveals that all the sound projects appropriate for International Bank financing which are now under consideration can readily be handled by the Bank with its existing resources. And, although it is impossible to predict future developments with certainty, there is every indication that the Bank will be able to raise sufficient new money in the market over the next few years to take care of such additional sound projects as may be presented. It must be remembered that the preparation of specific projects up to the point where they are ready for financing requires considerable time. Relatively few of the plans now under consideration by the other American Republics have reached that point, and it would be unrealistic to assume that all will reach it at once. Many of such plans, too, are not necessarily suitable for financing with foreign capital or in the form of long-term loans. Experience has consistently indicated that the rate of spending for long-term projects is considerably slower than loan applicants anticipate.

The history of loans to the other American Republics by the Export-Import Bank strongly supports the view I have expressed with respect to the adequacy of the International Bank's resources. During all of its history, the Eximbank has never had outstanding on such loans disbursements in excess of $262 million. Moreover, the fact that withdrawals are being made at a very slow pace by the other American Republics against authorized credits of roughly $200 million still available to them at the Eximbank shows how difficult it is for such countries to absorb substantial amounts of capital quickly. It is true that supply difficulties and the fact that the proceeds of Eximbank loans can be used only in the United States have tended to limit the use of Eximbank funds, but it is still unrealistic to suppose that capital requirements in Latin America will multiply over-night.

In what I have written, I have taken into account the fact that the International Bank is authorized, and in my opinion will in some cases be called upon, to supply a portion of the local currency funds for development projects, in addition to the funds needed to finance imports of equipment and material. In the "Project of Basic Agreement of Inter-American Economic Cooperation", prepared by the Inter-American Economic and Social Council for consideration at the Bogota Conference, the provision appears (Article 17) that "in general international financing should not be sought for the purpose of covering expenditures in local currency", but that "as long as the available domestic savings in the local capital markets are not sufficient, expenditures in local currency can, in justified circumstances, be considered" for International Bank and intergovernmental financing. With the understanding, as expressed, that international financing must not be relied upon as the primary source from which to meet local currency requirements, this seems to me an appropriate provision, and one which is consistent with the International Bank's charter and its intended method of operation.

You understand, of course, that the Bank cannot make loans to the other American Republics simply on the basis of need; it is not a relief agency. Before credit is extended, the Bank must satisfy itself not only that the project for which financing is sought is sound, but also that there are reasonable prospects of repayment. This requirement makes it a necessary part of the Bank's policy that countries whose economies are weak and whose credit standing is poor may qualify for a loan only if, concurrently with the granting of the loan, they adopt such measures for the maintenance of their financial and monetary stability and the reestablishment of their credit as may appear necessary in the particular case. This does not mean that all the remedial measures required must be completed before a loan is granted; to the contrary, financial assistance from the Bank may form part of an integral plan involving both long-range development of productive facilities. Adherence to this policy is believed necessary, not only to assure that the Bank's loans are productive and reasonably safe, but equally to ensure sound and continued progress in the development of the borrowing country. I may add that encouraging progress in that direction has already been made by some of the American Republics with which the Bank is currently conducting loan negotiations.

The productive potentialities of Latin America cannot be fully realized in one effort; sound development is a continuous and necessarily a long and gradual process. But rapid progress is nonetheless possible. It is our firm intention that, by applying the Bank's resources in the proper places and under proper conditions, the Bank should make a substantial contribution toward this end.

Sincerely yours,

John J. McCloy
President

CONFIDENTIAL

Secretary's Memorandum No. 379

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

FROM: THE SECRETARY

April 6, 1948

Secretary's Memorandum No. 373, dated March 22, 1948, circulated a letter of March 12 from Mr. Norman Armour, United States Assistant Secretary of State for Political Affairs, to the President of the Bank; together with a suggested reply by Mr. McCloy.

This reply was forwarded to Mr. Armour under date of March 23, together with "Annex A" referred to at the end of Paragraph 2. This Annex is circulated herewith in order to complete the record.

Distribution

Executive Directors and Alternates
President
Vice President
Department Heads

Sec 2-203
MMM/B

BANK ACTIVITIES IN LATIN AMERICA

Bolivia

Following an inquiry on behalf of the Bolivian Development Corporation in respect of a proposed loan of U.S. $3 million for the erection of a sugar mill, the Bank, at the invitation of the Bolivian Government, has agreed that the mission sent to Peru will move on to La Paz at the end of March in order to study the general situation in Bolivia.

Brazil

Brazilian Traction, Light & Power Co., Ltd., approached the Bank for a loan of U.S. $100 million on April 30, 1947, to finance part of the cost of increased capacity to be completed in 1947, 1948 and 1949. The foreign currency requirements of this program were U.S. $62 million. Following a study of the data furnished by the Company during May and June, an engineering survey of the Company's properties and an economic survey of conditions in Brazil were undertaken during July and August. The engineering report indicated the necessity of a comprehensive review of cost estimates due to a sharp rise in prices here and in labor costs in Brazil since the original estimates were made. In the light of the increase of costs, the Company thereupon set about revising the construction program. In December, a revised program was submitted by the Company which contemplated a loan of U. S. $75 million, to be guaranteed by the Government of Brazil. In the new program, the period of construction was extended through 1951, and the loan applied for was to cover the foreign currency requirements of electric and telephone plant additions. Gas, water and tramway expenditures, included in the original proposal, were omitted, the Company having decided to carry through such additions to these services as their own resources might permit. Representatives of the Company and of the Government (the Government's representative did not arrive until February 5) have been discussing, with Bank officials, the terms of such a loan and the legislation necessary to implement the proposed guarantee. The bill to authorize the guarantee has been favorably reported upon by the Finance Committee of the Chamber of Deputies and will be taken up again when the Brazilian Congress reconvenes this month.

Chile

On October 7, 1946, the official Chile Development Corporation and the Chilean State Railways applied for a loan of U. S. $40 million, to be guaranteed by the Chilean Government, to finance electric power plants and related distribution and irrigation facilities, forest industries, urban and suburban transportation, port mechanization and railway electrification projects. The general economic and financial situation of Chile, as revealed in studies made by the Bank, gave the management cause for grave concern. This concern was expressed to the official representatives of the Chilean Government on May 21, 1947. Particular reference was made to the persistence of unbalanced budgets and deficit financing, to the advisability of limiting non-essential imports and the building up of foreign exchange reserves to meet future expected deficits in Chile's balance of payments, to the unsatisfactory system of the multiple foreign exchange rates in effect, to unsatisfactory tax and exchange relationships with foreign enterprises in Chile, and to the impairment of Chile's international credit due to unsettled defaults of Chile' foreign debt. By October, 1947 it appeared that certain budgetary, fiscal and foreign exchange reforms had been initiated, and at the invitation of the Chilean Government, a mission from the Bank was sent to Chile in December, 1947 and January, 1948, to study the general economic and financial situation, as well as the projects for which loans were asked. At the end of January, Chile reached an understanding with the International Monetary Fund envisaging gradual replacement of the system of multiple exchange rates. Negotiations are well advanced for an initial loan to the Development Corporation in the amount of about U. S. $16 million, to be guaranteed by the Chilean Government, for two hydroelectric plants, together with distribution and irrigation facilities, for two additional generating units in existing power plants, and for agricultural machinery. The remaining items in the loan application have not been rejected, but are being investigated for future consideration; in particular, independent engineers are now in Chile studying the railway electrification project and the Bank is collaborating in sending engineers on the forest industries projects.

Colombia

Through the Governor of the Bank for Colombia, the Government requested the Bank, at the end of January, 1948, to lend its advice and assistance in the selection of competent advisory and engineering services in the United States and, if possible, in making contact with investors, in connection with a proposed steel mill in the Northwestern part of Colombia. The possibility of an application for a loan from the Bank is envisaged. The Bank replied, on February 4, stating its readiness to give the assistance asked for and requesting to be supplied with data. A survey previously made of the projected plant is to be furnished to the Bank for study and consideration when representatives of the Government, who are now inspecting steel plants in the United States, reach Washington.

Costa Rica

Following an inquiry with regard to a loan for a U. S. $2.5 million housing project, an informal invitation was extended to the Bank to send a mission to Costa Rica early in 1948 to study the economic situation and development possibilities. As a result of the recent change in the Government, it is not known whether the informal invitation will be pressed. The Bank is continuing its studies of the Costa Rican situation while awaiting further developments.

El Salvador

An official of the Government of El Salvador visited the Bank on September 19, 1947, and together with a consulting engineer discussed the possibility of the financing by the Bank of a hydroelectric power installation in El Salvador. He stated that a study of the project by a firm of American engineers was under way, but that it was expected that some time might elapse before the plans were ready for submission.

Honduras

On January 27, 1948, an inquiry was received from the Government of Honduras with reference to a loan of U. S. $2 million to cover part of the cost of a proposed hydroelectric plant, plans for which had been drawn by an American engineering firm. The Government is to arrange to have the plans sent to the Bank for study, following which it is expected that the Government will invite the Bank to send representatives to Honduras for the purpose of studying the economic and financial situation there.

Mexico

The Government of Mexico submitted an application for a loan of U. S. $208,875,000 on April 11, 1947. The application covered a series of hydroelectric, irrigation, oil pipeline, railway, port and highway projects. The application contained very little detailed information and, moreover, contemplated that the Bank would finance local peso expenditures to the extent of two-thirds to three-quarters of the total loan. The Bank indicated to the Mexican representatives that much more information on the particular projects and their relation to the general Mexican economic situation was required. A Bank representative was sent to Mexico in October, 1947, to familiarize himself with Mexican economic conditions and to advise with the appropriate Mexican authorities in the preparation of the required additional information. It is anticipated that this new data will be submitted to the Bank by the end of March. At that time, the Bank and the representatives of Mexico will renew discussions, looking towards the financing of projects on mutually satisfactory terms.

Peru

No loan application has been received from Peru, but, on December 23, 1947, the Peruvian Government requested that a mission be sent to Lima in order to study the Peruvian financial situation in general, and the possibilities of foreign investment in Peru. The Bank mission has left for Peru and will be operating there during the month of March.

The Bank has received a number of other loan inquiries from private sources relating to projects in Brazil, Chile, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela. In replying to these inquiries, the Bank has explained its procedures and methods of operation and has expressed its readiness to assist the countries concerned, in suitable cases, to work out the basis for an eventual loan application.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

ROUTING SLIP

Date 1/30/48

TO-	Name	Room No.
1	~~Mr. Richard H. Demuth~~	~~1023~~
2	Mr. Rist	306
3		
4		

FOR-

Action		Initialing	
Approval		Preparing Reply	
Comment		Previous Papers	
Filing		Noting and Returning	
Full Report		Recommendation	
Information		Signature	

REMARKS

This is my paper on development which I told you about.

It is my last copy and I would appreciate if you could send it back to me after perusal.

FROM- L.B. Rist

OFFICE SERVICES 13-12

I assume the economic aspects properly said will be covered by the other speakers and I expect therefore to confine myself to the financial problems involved in any consideration on the development countries. As you may expect, I am speaking purely in my personal capacity and not for the organization to which I belong. Furthermore I do not intend to bring you solutions, but only to describe to you the problems as they appear to me. There are several aspects which may require some thoughts : one of them is, obviously, the internal financial system ; another is the financial relations with the external world in its two forms direct investment and loan capital. We shall attempt to deal with them in turn, while underlining their close relationship.

I. - INTERNAL FINANCIAL PROBLEMS

Financial difficulties may have two aspects. They may be due to underlying economic conditions and be thus the effect or symptom rather than the cause. In other cases they may, on the contrary, be rather the cause than the effect.

Roughly speaking there are five groups of economically underdeveloped ~~backward~~ areas :

Eastern Europe
Middle East
Far East
Colonial Territories
Latin America

The first three are characterized by overpopulation. Colonial territories present special problems. Latin America, however, is a special case for at least two reasons :

a) it is underpopulated rather than overpopulated and further industrial developments may well have to be linked with some immigration,

b) It may well be the only case where financial troubles are the cause rather than the effect of economic difficulties. Since these financial troubles are sometimes a deterrent to economic development any action likely to cure them might be said to be in itself directly productive.

All groups are very interesting and deserve individual description but a good deal has already been published on the other groups. While Latin America is not only a special case but also an easier and simpler one, my paper will deal essentially with it.

It is an almost constant fact that in all countries of Latin America internal credits have never developped to any considerable extent except, lately, in Argentine. Self financing is the exception. They suffer from chronic inflationary tendencies in spite of the fact they have been spared by World War I and World War II. It is easy enough to ascribe these features to political unrest, but it should not be forgotten that political disturbances are just as much a consequence as a cause of low standard of living, social inequalities and unsettled economic conditions. We can, therefore, speak of the financial structure of these countries without referring any further to the intricacies of their political life.

Inflation in South America has several causes ; one of them, most often reffrred to, is imprudent budget practices, including heavy investment or military expenditures and ~~primitive~~ unflexible taxation systems. While these reasons are undoubtedly of major importance, I venture to doubt whether they have the same significance everywhere and whether they are not intimately tied up with social structures which could only be changed by a general improvement in the standard of life.

Other causes of inflation seem to me nearly as important :

one of them is the great reliance on exports which during the war especially allowed for the creation in South American countries generally of a large amount of purchasing power. ~~which,~~ Failing appropriate sterilization policies, it could not be offset by corresponding imports. The external sign of this was an accumulation of foreign exchange which is now being rapidly spent.

Another cause of inflation is probably the development policy itself whatever the source of funds. The mere fact that internal currency is devoted to building of productive installation, indluding housing, means that the consumer's income is enlarged without correspondigg increase in the amount of consumers goods placed at his disposal. To the extent that the consumer saves actually a corresponding amount, there is provided both an escape for consumers outlay and a source for new investment funds. To the extent, however, that such savings do not take place, a pressure on prices of consumers goods ensues. Lacking a sufficient supply of funds, the government or the entrepreneurs have to call on bank credits, i.e. mostly Central Bank credits, for financing new investments. In other words, an investment policy carried out at a rate which is quicker than the rate of accumulation of savings brings about both inflationary pressure on prices and monetary expansion.

This short analysis is not intended to underrate the importance of budgetary and monetary practices as a cause of ~~engaging~~ the financial troubles of development countries, especially in South America. It is merely intended to bring home the fact that since development by itself like any other investment policy, may have inflationary consequences, internal fiscal policies are of the greatest importance. The dilemma is, of course, that conservative fiscal policies may, for a little while, at least, slow down the development policies which, for social or political reasons, the nation wishes to expand rapidly. The question is once more one of measure.

It should not be overlooked that in many cases savings are available locally for certain types of investments, provided the rate of return is ~~exceedingly~~ sufficiently high. It is another feature of the development countries that in view of the numerous profitable ventures that are open to the priviate initiative, the rates of interest are naturally relatively high, becaude the normal form of risk is ~~the~~ equity, rather than fixed income investment. ~~the ownership in a venture.~~ Thus, one of the most popular forms of investment is in real estate, because of its speculative attraction. Here again, a conspicuous exception is to be made for Argentine where things have been settled enough for a sufficient time. A relatively large market has developped in mortgage bonds (the famous "Cedulas Hipotecarias").

In some South American countries, the governments have made ~~an~~ attempts to direct investments towards the enterprises which seemed the most attractive for the nation as a whole rather than the most immediately profitable. Such is the purpose of the Fomento Corporaciones and it is well known that in the case of Chile for instance, the government undertakes the primary financing but expects to sell the equity in the newly created enterprises to the broad public after having set them in motion.

II. - EXTERNAL FINANCING

I have said before that most development countries were faced with a difficult dilemma : either maintain conservative finance practices or slow down for a while on their development schemes. The obvious way out ofthis dilemma is import of foreign capital. At first sight, this is a perfect solution : provided with foreign exchange thanks to the imports of capital, the country can purchase either the equipment needed for its development plans or the consumers goods the sale of which would restore equilibrium in an inflated market. The ideal is, of course, that the foreigner could bring both his capital and his skill and immigrate bringing with him his accumulated savings. This is, to an extent, how the United States, Canada, Australia, New Zealand and South America itself have been industrialized or developped, not to speak of the colonial territories.

Failing a combination of both capital and skill, import of equity capital is obviously the most natural course. Equity risk is for the foreigner as well as for the nationals the most attractive investment because of the chances of profit. At present, this movement is far from having stopped and Mr. Stacy May is undoubtedly among those who can speak the most authoritatively of the problems involved.

The form under which this capital can be solicited are numerous. They range from outright ownership abroad to participations in local corporations or partnership ventures, but the conditions of exploitation are just as varied. The most profitable for the outside investor is of course the case where all goods extracted or raised on the spot can be sold on his own terms, either internally or especially externally. In other cases, the foreign investor may organize a national establishment and only draw therefrom royalties of fees. Finally, he may limit his demands to the payment of dividends.

The objection to the heavy participation of foreigners in the operation of a country are too well known to be repeated. There have been abuses but on the other hand, it must be realized that retaliations of too stringent a character have a deterrent effect and may completely dry out the influx of foreign capital. Under the auspices of the League of Nations first, of the United Nations now, and, possibly, of the I.T.O. at a later stage, efforts are being made and will be made to find satisfactory compromises of a general character.

Loan capital is of a different character. It can flow either to enterprises or to governments. In the first case, there is no difference with a direct equity investment for the purpose of earning dividends except that repayment of capital is expected; in the second case, the government has the impression that it does away with the danger of foreign interference based on ownership, but at the same time it involves risks which cannot be underrated. In both cases repayment of the principal must be provided over a period. It is therefore both more costly and more rigid than direct investment. In times of depression this rigidity may lead to defaults.

The risk to the foreign investor has been stressed often enough and it may not be necessary to comment at length on the debt record of many under developped countries, but one or two points deserve mention. Firstly, most of the debts were incurred during a period of expansion, in other words, they did, to an extent, contribute to the inflationary trends ; readjustments during the down slope of the cycle were, therefore, made more difficult. Secondly, the reasons why the debts were incurred very often tied in directly with the internal financial situation. Lacking internal credits, many governments found it actually easier to borrow abroad rather than internally, sometimes because there was no capital available internally, sometimes merely because the rate of interest abroad appeared more attractive than the rate of interest on the spot. The delusive character of such a reasoning is clear enough. It could also be said that the absence of an internal public debt tradition may, in isolated cases, have been responsible for the easy acceptance of the default status or for its persistence during the depression years.

However uncautious some of the countries may have been in borrowing, however uncautious some investors may have been in lending, the need for loan capital still subsists. It cannot be assumed that in the near future the development countries will have restored their internal financial situation and stabilized their external finances to an extent sufficient for allowing them to finance their own needs. It can also not be expected that ~~foreign~~ private capital will be able to flow in amounts sufficient to cover not only the cost of building one profitable enterprise but the cost of supplying its site with the underlying facilities which are ~~so important~~ indispensable : transportation, public utilities, etc. Finally, foreign private capital cannot be expected to devote itself to improving the standard of life and the stability of the economies by improving the conditions of agriculture which remains one of the most important and perhaps ~~more neglected~~ often underrated activity in these areas. The rate of return of ~~financial improvements~~ investment in public utilities, land reclamations, modernization of agricultural methods can rarely be estimated in accounting terms. They involve large amounts ~~of~~ subject to concerted allocations and can only be fruitful under cooperative or government guidance. Their remuneration is in the form of easier standard of life, better tax returns, greater economic stability.

In view of these fundamental facts, I strongly believe that loans to development countries will continue to be made in the hope that progressively they may reach the stage at which self financing will not be an empty word.

Local Currency

DECLASSIFIED
Date: 11/15/2010 BHW

CONFIDENTIAL

Committee on Financial Policy
Document No. 33

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

June 14, 1948

COMMITTEE ON FINANCIAL POLICY

FROM: The Secretary

Memorandum on Loan Policy

As requested at the Twenty-Fourth Meeting of the Committee on Financial Policy held on June 10, 1948, the attached copy of Mr. Beyen's Memorandum on Loan Policy is circulated, and will be discussed at the next meeting of the Committee.

Distribution:

Members, Committee on Financial Policy
President
General Counsel
Loan Director
Economic Director
Treasurer
Secretary
Assistant to the Vice President

EMW:gm
Sec:2-280

To: Mr. John J. McCloy Date: March 16, 1948

From: J. W. Beyen

Subject: Loan Policy

1. At the 23rd meeting of the Committee on Financial Policy held on January 13, 1948, the subject of Interbank-loans for specific projects was brought up and it was agreed that this subject required consideration by the Committee. It would seem that the time has come to take up the study of this subject in order to get a clearer picture of what the policy of the Bank should be in this respect.

2. It is generally assumed that if and when the Marshall Plan is coming in operation, the Bank should withdraw from the field of so-called general purposes loans, such as have been given to France, the Netherlands, Denmark and Luxemburg. Financing imports of raw materials and fuel would be no longer the task of the International Bank who would concentrate in the future on the financing of imports of capital equipment.

3. During the waiting period in connection with the Marshall Plan the idea has come up that the Bank might usefully give loans for smaller specific projects. This idea was born from the desire to remain active (whilst awaiting the coming into operation of the Marshall Plan) within the limits drawn by the resources available to the Bank until the moment that a new bond issue could be placed on the market.

4. A new line of thought is now taking shape, however, namely that the Bank should concentrate on the financing of special projects even after it would again be able to extend its resources by access to the market. This line of thought commends itself for various reasons. It would seem that, once the Marshall Plan has taken care of the financing of balance of payment deficits, reconstruction will more and more take the form of rebuilding and extending certain well defined parts of a country's productive apparatus rather than of resuscitating the productive apparatus as a whole by the import of raw materials and items of equipment.

5. There are, however, a number of aspects connected with the financing of specific projects that should be studied before the Bank's policy crystallizes. Obviously it will not be possible to have an entirely clear picture of the character of such projects before they are actually presented to the Bank for investigation. It is likely therefore that the policy of the Bank cannot be defined in a clear-cut way as yet but has to remain flexible and adaptable. In that case, however, the Bank should avoid that its policy be fixed unintentionally by the force of precedents (created by the types of loan given in special cases) or by statements to prospective borrowers, to the press or to the market.

6. One of the characteristics of the financing of special projects is that only part of it will be definable as outlay in dollars. On the one hand a large part of the outlay will be in local currency or in currencies

other than dollars. On the other hand it is possible that the execution of a project indirectly causes a larger outlay in dollars for the country as a whole (see Art. of Agreement IV, Section 3 under (c)).

7. The fact that one cannot cut up the economy of a country in separate parts means that the effect of a special project loan on the balance of payments of a country is less easily traceable than the effect of a general purposes loan. This has a direct bearing on the question by what considerations the terms of amortization should be defined. In the case of specific project loans such terms should in principle be linked with the lifetime of the project. There is no a priori reason to link such terms with the additional foreign exchange accruing to the country as a consequence of the execution of the special project. But there may be cases in which such additional accretion has to be taken into consideration in whole or in part.

8. It is possible that in certain highly developed countries a greater specification of the purposes of the loans of the Bank cannot go so far as to take the form of the financing of a well defined special project. It may be for instance that financing the modernization of a certain industry would be the furthest step that can be taken in the direction of a narrower circumscription of the purposes of a loan.

9. It seems to me that the above-mentioned aspects of the Bank's future loan policy should be studied by the staff of the Bank and discussed in the Financial Policy Committee in preparation of a general discussion in the Board.

(Signed) J. W. Beyen

Sec:2-280

Record Removal Notice

File Title	Barcode No.
Policy Issues of Importance - Correspondence 02	1849865

Document Date	Document Type
23 April, 1947	Board Record

Correspondents / Participants

Subject / Title

Discussions on Policy at the 83rd Regular Meeting of the Executive Directors Held on April 2, 1947 (M - 83) (Supplement)

Exception(s)

Additional Comments

Declassification review of this record may be initiated upon request.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information. This Policy can be found on the World Bank Access to Information website.

Withdrawn by	Date
Chandra Kumar	30-Oct-14

Cathedral

Mention for initials

Clause "Loan policy"

Mr. Robert L. Garner, Vice President

May 9, 1947

D. Crena de Iongh, Treasurer

I am sending you herewith a memorandum written by Mr. Gordon Street of my department on the German Potash Loan. As you may remember, I thought that the German Potash Loan, being one of the few bond issues secured by external collateral, might serve as a pattern for a Polish loan of the Bank to be secured by proceeds of coal exports.

As can be seen from the memorandum, much depends in this case on the way the covenant is executed. In order to get more background information, I went to see the Schroder Banking Corporation in New York, who told me that the actual handling of this matter had been done entirely in London. I intend, therefore, to take advantage of my next visit to London to see the Schroder people there.

I might point out also that the Continentale Handelsbank in Amsterdam, which served as an intermediary in this matter and was owned by the Potash Syndicate, was seized after the war by the Dutch Government and was then managed for the Netherlands Government by Professor G. W. J. Bruins, now an Executive Director of the Monetary Fund. Professor Bruins was succeeded by Mr. Paul Jaffe, a former member of the banking house of Pierson & Co., who is also a personal friend of mine. I think that in case we wanted to use a similar organization for Poland, we could benefit very much from Professor Bruins' experience, and might even use Mr. Jaffe in setting up such a system for us in Poland if the Bank wanted to have its loan secured in such a way.

DC/mct
enc.

cc Mr. Pineo
Mr. McLain
Mr. Rist

THE POTASH SYNDICATE OF GERMANY
25-YEAR SINKING FUND GOLD LOAN

The Potash Syndicate of Germany was organized October 16, 1919, pursuant to a special act of the German Legislature to control the German industry, by giving to it the sole right until 1953 to produce, sell, distribute, export from and import into Germany potash and its compounds. The only large developed deposits were in France and Germany at the time bonds were originally issued. These deposits were extensive with estimated reserves sufficient for several centuries. Sales for fertilizer and chemical products were made throughout the world, principally to the U. S. A., United Kingdom, Denmark, Holland, Norway, Sweden and Switzerland. The owner of each potash mine and factory was required to become a member and was alloted participation in the industry. The members produced according to their participation, handing their production over to the Syndicate. Sales and profits were distributed to members on the basis of this quota. Members bore the expenses of the Syndicate, which was a non-profit organization.

The Syndicate had 144 members in 1925 owning 221 mines with factories and seven independent factories, many of which were closed in view of decreased demands. Moody's Industrial Manual (1946) reports that there were 34 members at the close of 1945 owning 229 mines with factories and 8 independent factories. 40 of the 229 mines were reported to be in operation in 1940. The members were to a large extent grouped into concerns (or groups) each of which were under centralized management.

Management was vested in a 5-man Board of Managing Directors and a Board of Supervisors consisting of certain members. The German Government supervised the whole industry through a council on which the Syndicate was represented. Thus it is evident that the industry was prepared for a loan on an industry-wide basis.

On December 6, 1925, the Syndicate entered into a Trust Deed with the Royal Exchange Assurance, of London, for the purpose of issuing £15,000,000 principal value of bonds which were subsequently issued in three series: £8,000,000, Series A, 7%, due 11/1/50; £4,000,000, Series B, 7%, due 11/1/50; £3,000,000, Series C, 6½%, due 7/1/53. Proceeds of the bonds were used to develop the Potash Industry by expansion, modernization and improvement of the factories and facilities and to reduce the outstanding floating and funded debt of the members of the Syndicate.

Under the terms of the Trust Deed, the bonds were secured by:

(a) the direct obligation of the Syndicate as to payment of principal and interest in sterling or dollars;

(b) the several guarantees of members of the Syndicate in the proportion in which they participated in the proceeds of the bonds;

(c) mortgages on the mining and manufacturing plans of the individual members to the extent of their guarantees; and

(d) a first charge on the proceeds of the sale of potash to countries outside of Germany.

The direct obligation of the Syndicate was strengthened by the provision of the Trust Deed that the Syndicate enter into an agreement with each of the participating members (called assignments of participation) by the effect of which each of the participating members transferred to the Syndicate its present participation in the Potash Industry.

By a supplement to the Trust Deed each of the members of the Syndicate agreed to all the terms of the Trust Deed and unconditionally guaranteed the bonds as to interest, principal and premium up to a certain amount per member in accordance with a schedule attached to the Trust Deed; the totals of the several guarantees being equal to the total amount of the loan. The above mentioned schedule also listed the total amount of the outstanding debt of each member, other than that existing under the Dawes Public Loan, and the members in the supplement to the Trust Deed covenanted to pay off such debt as scheduled prior to a fixed date out of the proceeds of the sale of bonds, and if this was not accomplished, the "Receiving Bank", which is discussed below, could under the terms of the Trust Deed retain out of the proceeds from the sale of potash to countries outside of Germany received by it an amount equivalent to such debt remaining outstanding. This in effect amounted to indirect supervision over the use of the proceeds of the loan. The method by which the "Receiving Bank" should receive the proceeds from the sale of potash and the method actually used in practice are discussed below.

To the extent of its guarantee each member gave to the trustees a mortgage on its properties as security for its obligation. The bondholders were further protected by provisions preventing the obligating of other debts by the Syndicate or its members, and requiring proper maintenance and protection of the properties.

The Syndicate agreed to the appointment of J. Henry Schroder and Co. as the "Receiving Bank" to supervise the disposal of the proceeds of the sale of all potash exported either directly or indirectly to countries outside Germany, while the bonds remained outstanding. The Syndicate undertook "that during the currency of the loan, it will give all such authorities and directions and do all such acts and things as shall be necessary to ensure that all proceeds of the sale of potash so exported shall be received by the Receiving Bank. . ."

Under the terms of the Trust Deed, the proceeds from the sale of potash received from the Syndicate by the "Receiving Bank" were held by the latter as follows in the order listed: (1) set aside in each calendar month 1/12 of the annual service charges and made service payments as noted below, (2) made up any deficiencies in monthly installments of previous months, (3) deducted all charges and expenses of trustees and paying agents, including exchange losses to paying agents arising from payments of interest in dollars at the fixed rate of $4.86 per £, (4) held at disposal of Syndicate. The Trust Indenture further provided that the proceeds of the sale of potash exported to the U. S. A. and the U. K. should be utilized first to set aside sums for the service of the bonds.

As to the service of the bonds, the Trust Deed provided that 28 days prior to each semi-annual interest payment date, J. Henry Schroder and Co. would place a fixed amount of sterling with the paying agents. If J. Henry Schroder and Co. had not received sufficient funds from the proceeds of sales, the Syndicate was required to make up the necessary balance. The fixed amount of sterling (£648,889 aggregate for all series) applied toward the semi-annual interest payments and the balance constituted a sinking fund to be used to repurchase bonds at 102½ or lower during the interval until the next semi-annual interest payment date. If bonds could not thus be purchased, the sinking fund was employed, at the end of 13 weeks, to purchase bonds drawn by lot at 102½. All bonds repurchased by the sinking fund had to be cancelled.

Thus, the general procedure by which the proceeds of external sale were applied to servicing the bonds before providing for operating expenses of the Syndicate or its members is outlined in the Trust Indenture. However, the details as to the operation are not apparent. The Trust Deed does not disclose the nature of the "authorities and directions" and "all such acts and things as shall be necessary to ensure that all proceeds of the sale of potash so exported shall be received by the Receiving Bank."

A discussion with Professor G. W. J. Bruins revealed the details in brief. All potash exports of the Syndicate were sold through an international cartel which operated selling companies in 33 countries throughout the world. This selling organization was established at the time the Trust Deed was signed by an agreement between the German syndicate described above and a similar French syndicate which operated all the Alsatian potash mines obtained from Germany following World War I. The headquarters of the vast selling organization were located in Amsterdam. The French and German syndicates shared the management on an equal basis but sales and profits were applied in the ratio of 70% to the German syndicate and 30% to the French, which was the approximate ratio of potash available for export produced by the two organizations. The cartel also owned or controlled all of the existing potash production facilities outside of Germany and France except for those in Russia and a few minor units in Spain. As a result of this organization, the sales of potash, similar to production, were under the administrative control of one organization.

The "Receiving Bank", J. Henry Schroder and Co., did not supervise the sales operations of the selling cartel, but through inter-corporate connections was able to maintain an eye on the process. Proceeds of all sales except those in the U. S. A. were sent, not to J. Henry Schroder and Co., but to its agent in Amsterdam, the Continentale Handelsbank N. V. The latter bank serviced all bonds except those held in the U. S. A. on which service was handled by J. Henry Schroder and Co. The Continentale Handelsbank was closely related to the potash selling cartel as the cartel owned 50% of the stock of this bank and was represented on the Board of Directors by two of the seven men making up the Board. The selling organization, which incidentally was interested in other products, was one of the Continentale Handelsbank's largest customers, if not the largest. It was evidently through this interrelationship and common business interest that the "Receiving Bank", or in actual practice, its agent in Amsterdam was able "to ensure that all proceeds of the sale of potash so exported shall be received by the Receiving Bank . . ." The "Receiving Bank" did not take over control of potash exports but merely received the proceeds of sales and relied upon its connection with the selling organization to receive all the proceeds.

It is of interest to note that the proceeds of the sale of potash under this monopolistic production and sales organization were sufficient to meet the service charges many times over. Interest was paid through July 11, 1941 and sinking fund payments have been in arrears only since November 1, 1940 on Series A and B, and since May 1, 1941 on Series C. Moody's Manual (1946) reports that the following amounts remained outstanding on March 26, 1946: Series A - £3,683,450, Series B - £1,826,870 and Series C - £2,146,550.

Summarizing the story, the following important points stand out:

a. Production was centralized under one organization with which the creditor dealt, while at the same time properties of the individual producers could be pledged as security for the loan. The situation regarding Polish coal is somewhat comparable as all Polish coal mines were nationalized on the basis of the law of 3 January 1946 and the industry is operated under the control of the Central Board of Coal Industry located in Katowice which is controlled by a government ministry.

b. Sales of potash from practically all sources were controlled by a selling group of which the borrower was a major participant, and the demand for the monopoly's product was established. The situation regarding Polish coal is certainly not comparable. Coal is produced in several countries of the world and Poland's favorable position will probably not continue indefinitely.

c. Sales were centralized under one organization which forwarded proceeds of sales to a closely related "Receiving Bank" which applied them to servicing of the bonds prior to meeting operating expenses of the producing or selling companies. Sales of Polish coal are now under the control of the Polish Government through the intermediary of the Central Board of Coal Industry. It would be necessary to reach agreement with the Polish Government as to arrangements whereby the IBRD would receive the proceeds from the external sales of coal, or a portion of external sales, for instance, sales to western Europe.

GS:lms

CONFIDENTIAL

COPY NO. 6

DECLASSIFIED

Date: 11/20/2010 BAW

April 7 1947

DRAFT MEMORANDUM ON LOAN POLICY

1. The primary purpose of the Bank is to "assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peace-time needs and the encouragement of the development of productive facilities and resources in less developed countries."

2. In carrying out that purpose the Bank is to "promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources."

3. The Bank is further enjoined to "promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources of members, to arrange "the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, will be dealt with first"; and to "conduct its operations with due regard to the effect of international investment on business conditions in the territories

of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to a peace-time economy."

4. Furthermore, in making or guaranteeing any loan the Bank is required to "pay due regard to the prospects that the borrower, and, if the borrower is not a member, that the guarantor, will be in a position to meet its obligations under the loan"; and to "act prudently in the interests both of the particular member in whose territories the project is located and of the members as a whole."

5. The Bank is, therefore, a cooperative financial institution designed to promote mutual assistance among its members in the reconstruction and development of their territories and the promotion of the long-ranged balanced growth of international trade and the maintenance of equilibrium in balance of payments.

6. With due regard to the purposes of the Bank as set forth in the Articles of Agreement; to the magnitude of its task of assisting in the economic and financial recovery of the world; to the responsibilities of the Bank towards its members as stockholders and potential borrowers, and towards the investors who must supply the major portion of its loanable funds - these are adopted as principles governing its loan policy:-

7. 1. <u>The Need to take calculated risks</u>

It is essential for the Bank to take calculated risks that private capital is not now willing to assume, especially risks arising from general economic and political uncertainties, and from the magnitude of the amounts required.

8. 2. The Need to insist on Constructive Lending.

In accepting these general risks, it is necessary for the Bank to insist that the purposes for which its funds are used are constructive, practical and essential to the economic rehabilitation or development of the borrowing countries, and beneficial to the world economy.

9. 3. Distribution of Loanable Funds.

Since the Bank's resources are limited in relation to the demands to be made upon it, it is not enough to consider individual applications on their merits. First consideration should be given to the most urgent needs whether for reconstruction or development; these can be defined broadly as the elimination of bottlenecks and the restoration and expansion of productive facilities that will contribute most effectively to the healthy revival of the world economy.

10. 4. Principle of Successive Advances.

The principle of successive advances arises from two reasons:

First, the Bank's purpose is not fulfilled by the mere granting of loans. It has a continuing responsibility regarding the utilisation of its loans. This responsibility can best be discharged by meeting the needs of borrowing countries with successive advances in the light of their own performance, and by the maintenance of close collaboration between the Bank and borrowing countries.

11. Secondly, the present limited resources of the Bank preclude it from providing finance for a long period ahead for all the

qualifying applications. The Bank can lend no faster than it can borrow. Its current policy must, therefore, be one of making successive advances to individual borrowing countries to meet their most important needs as they arise.

12. 5. Primary Responsibility of the Borrower for the Major Contribution to its Recovery.

The Bank shall proceed on the basis that, important though its financial contributions can be, the major effort must be made by the borrowing countries. The future of every country must depend primarily on its willingness and ability to utilise to the fullest and for productive purposes its own resources.

13. 6. The Fulfilment of Contracts.

In view of the fact that the realisation of the purpose of the Bank - to assist in economic recovery and development, both by direct or guaranteed loans, and by the encouragement of private lending - depends on its ability to work towards the opening up of all sources of finance, it has an inescapable interest in the fulfilment of obligations in good faith. Therefore, it has responsibility for appraising fairly all factors affecting confidence in international loans and of encouraging all steps which tend to promote such confidence.

14. 7. The Use of the Proceeds of Loans

The Articles of Agreement provide that arrangements should be made to ensure that the proceeds of loans are used efficiently for the specified purposes. Such arrangements should ensure that:

(1) Disbursements are for expenditure on goods and

services acquired in accordance with the terms of the loan agreement; and

(2) The goods and services so purchased are employed for the purposes stated in the loan agreement.

15. 8. Technical Advice.

The efficient utilisation of loans depends, in large measure on the quality of the engineering and other technical skills employed not only in the preparation of projects submitted, but also in their execution. Accordingly, the Bank will scrutinise carefully the engineering and technical skills used in the preparation of projects and proposed to be used in their execution. ~~Where an applicant for a loan does not have available the requisite engineering and technical services,~~ The Bank will be prepared to consult with and advise the applicant as to how such services can best be provided.

16. 9. Interest on Loans, Commissions and Conditions of Redemption.

Subject to modification in the light of changing conditions:

(a) Rate of Interest on Loans.

The rate of interest on loans made by the Bank shall be stated separately from the rate of commission to be charged on such loans.

17. Such rate of interest shall be not more than approximately one-quarter of one per cent. per annum higher than the net rate of interest at which the Bank can reasonably expect to borrow at long-term

an amount equal to the amount of the loan.

from the date of the

18. Interest at such rate shall be charged on the full

use of the funds and a commission at the rate of 1½ %. when

~~amount of the loan from the date on which~~ the Bank undertakes a firm commitment to make the loan. In exceptional cases of projects requiring a long period of time to complete, some modification of this principle may be necessary.

19. (b) Commission on Loans

The rate of commission to be charged by the Bank on loans made by it shall be one per cent. per annum on the amount of the loan outstanding and such commission shall be charged on all loans made by the Bank whether made out of capital or out of borrowed funds.

20. (c) Provisions for the Redemption of Loans prior to Maturity at Option of the Borrower.

Loans made by the Bank shall be subject to redemption at any time prior to maturity at the option of the borrower.

21. Upon optional redemption of all or any part of the loan prior to maturity the borrower shall be required to pay a premium at a rate approximately equal to the rate of premium which the Bank shall reasonably expect to have to pay on the optional redemption of securities issued by it having substantially the same maturity.

22. The Bank at its option may waive the payment of all or part of such redemption premium on the optional

redemption prior to maturity of loans made by it when the Bank is satisfied that it can use the amounts of the loan so repaid to retire its own securities without loss of interest or otherwise use such amount in its operations.

23. 10. Protection of Bank's Loans.

The Bank is required to protect the integrity of its loans. Since such loans will be repayable in foreign exchange, the Bank must provide suitable protection against the borrower impairing its ability to provide the necessary foreign exchange either by pledging its foreign exchange resources as security for other external debt or by improvidently incurring an excessive amount of external debt. To that end the borrower should agree not to pledge its sources of foreign exchange so as to give other external debt priority over the Bank's loans without the consent of the Bank. ~~In appropriate cases~~ an exception to this principle may be made in order to permit short-term self-liquidating transactions. The borrower should also agree not to incur additional external debt without advising ~~first consulting with~~ the Bank.

24. 11. Relations between the Bank and Borrowing Countries.

In order to accomplish its purposes, the relations between the Bank and its members must be based on confidence and a spirit of mutual cooperation. The relations of the Bank with its borrowers must be broader and closer than the ordinary relations between a creditor and a debtor. There must be the fullest exchange of information with regard to all matters of mutual interest and full opportunity to consult and advise with each other on all such matters. That must be true not only at the inception of the loans but throughout the life of the loans.

25. Since the financial assistance rendered by the Bank will provide only a part of the resources which the borrower will require for the accomplishment of the particular project or program for which the loan is made, and since in the end the accomplishment of such project or program must depend on the constructive efforts and savings of the government and people of the nation to which the loan is made, both the Bank and the borrower must be assured that those efforts and savings can and will be mobilised.

The Bank, therefore, has an interest in:

(a) Internal economic and financial measures taken by the borrowers to implement their reconstruction or development programs;

(b) Continuing developments relating to the economic and financial progress of the borrower.

26. 12. Recognition of Principles in Contracts.

The contracts of the Bank with its borrowers should contain appropriate recognition of the principles here enunciated and appropriate provisions to implement such principles. Such principles are necessarily subject to modification from time to time in the light of changing conditions.

Lending Policy

R - 74

CONFIDENTIAL

DECLASSIFIED
Date: 11/15/2010 BAW

(To be submitted to the Executive Directors on January 22, 1947.)

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

January 21, 1947

MEMORANDUM FROM K. VARVARESSOS

Re: Report (R-71) of the Committee on Financial Policy

I should like to draw the attention of the Board on the following issues raised by the Report of the Committee on Financial Policy.

In dealing with the concrete problems facing the Bank it is difficult at times not to lose sight of the wider purposes which the Bank has been created to meet. In establishing the policies of the Bank, it is, however, essential to keep these purposes in mind.

I have already had the opportunity to stress the fact that the Bank is not an ordinary money-lending institution concerned exclusively with the profitability of its loans, but is an inter-governmental agency established with the primary object of providing the means for the orderly economic reconstruction and development of the world. It is impossible to exaggerate the importance of the task entrusted to the Bank. The war has greatly intensified the serious disparity of productive capacities existing between countries which, already before the war, was an important cause of disequilibrium in the world economy.

Only if the countries devastated or dislocated by war are effectively assisted in reconstructing their economies will it be possible to attain, within a reasonable period of time, some measure of exchange stability and freer economic intercourse between nations. Without such assistance, restrictions and controls of unprecedented severity will have to be adopted in a large part of the world which will distort the world economic structure and hamper the flow of world trade. Without such assistance neither the International Monetary Fund nor the International Trade Organization can hope to achieve any success in their fields.

In entrusting to the Bank the task of assisting in the reconstruction of the world, the Member governments have, therefore, made the Bank a key factor in world recovery.

The success of the Bank will, however, depend not only on the scale of the assistance it will provide, but also on the conditions under which it will provide that assistance. The Bank must constantly keep in mind that the countries concerned will, to a very large extent, be borrowing funds not in order to increase their wealth or develop their productive capacity, but simply in order to make good the losses and dislocations of war. The margin for the servicing and repayment of loans will, therefore, be small and will, in any case, require the most careful use of the foreign exchange resources available to those countries. The larger the payments that will have to be made for the servicing of loans, the more severe the restrictions that will have to be imposed and the smaller the resources that will be available to finance essential imports. If, moreover, one takes into account the fact that, unlike the loans granted in the past, the loans of the Bank will call for large-scale internal financing as well, one is bound to conclude that the task of reconstruction will, in any case, place a severe strain on the balance of payments of the countries concerned and that the larger the payments they will have to make for the servicing of loans, the more severe will be the strain they will experience on their balance of payments. There can be little doubt that the world will soon be faced with a serious shortage of dollars. Any action of the Bank that will increase the world's requirements of dollars is bound to aggravate the world-dollar problem and render it more intractable.

The Report of the Committee on Financial Policy is based on the principle that the Bank should aim to "build up a surplus". The object of such surplus would be

(a) to enable the Bank to meet "all manner of risks" and "carry on its business and meet its obligations without recourse to the unpaid capital even if it has to suffer postponements or defaults on its loans"; and

(b) to pay a dividend "in the more distant future".

On the basis of the recommendations of the Committee and the calculations contained in the Report, the borrowing countries would, in the next decade, have to make payments for the servicing of the loans (excluding amortization) of over 2.2 billion dollars, as follows:

Payment of interest at 3¼%		$1,780,594,000.
Payment of commission 1 %		462,747,000.
	Total	$2,243,341,000.

Of this total, nearly 1 billion dollars will represent payments by borrowing countries in excess of the cost to the Bank of its funds and operations, as follows:

Difference between interest on loans at 3¼% from the date of commitment and interest paid on borrowed funds (3%)		$ 447,844,000.
Interest earned on borrowed funds		38,980,000.
	Total	$ 486,824,000.
Commission charged on disbursement		462,747,000.
	General Total	$ 949,571,000.
	Operating Expenses	- 25,625,000.
		$ 923,946,000.

The payment of a commission is required by the Articles of Agreement for the building up of a security reserve. Of the additional burden of \$460,000,000., however, the largest proportion is the result of the following recommendations of the Committee:

(a) that the Bank establish a margin of ¼ per cent between the interest paid by it on its borrowed funds and the interest charged on its loans; and

(b) that interest be charged on the loans made by the Bank from the date of commitment instead of from the date of disbursement.

If no such margin in interest rates were established and if interest were charged from the date of disbursement, the sum of \$460,000,000. would be reduced to \$94,472,000. as follows:

Difference between interest on loans at 3% from the date of disbursement and interest paid on borrowed funds		\$ 55,492,000.
Interest earned on borrowed funds		38,980,000.
	Total	\$ 94,472,000.

Added to the commission, this sum would still bring the total surplus to be accumulated by the Bank during the first decade of its operations to \$557,219,000; a by no means negligible amount if one takes into account that to a very large extent it will represent dollar payments by countries devastated or dislocated by war.

The question, therefore, arises: would the Bank be justified in imposing on these countries additional payments of \$365,000,000? In my opinion it would not.

Including amortization, the borrowing countries will have to make payments during the next decade well in excess of 2 billion dollars. For any-one who has examined the prospects of these countries and of the world economy, there can be little doubt that the transfer of such a large amount of dollars will in any case present formidable difficulties and will be possible only under favorable world economic conditions. The larger the amounts to be transferred, the greater the difficulties and the greater the risk of defaults. An additional burden of nearly $400 million as envisaged by the Committee may well tip the scales and produce those very defaults which the Bank is so anxious to avoid. It should be remembered that defaults in the past have seldom been total defaults. In the great majority of cases they consisted in the suspension of amortization and reduction of interest payments. It is, however, these partial defaults which were responsible in the past for the collapse of international investment and the reluctance of private investors to make their funds available for foreign lending. By imposing too heavy burdens on the borrowing countries, the Bank may seriously increase the risk of defaults which will inevitably affect its standing in the capital markets.

We must not forget that the burden which the borrowing countries will be undertaking, even under the most favorable terms that the Bank may grant to them, will be formidable enough. It is sufficient to compare the terms of the American loan to Britain with the terms under which the Bank may grant loans to realize the disadvantage at which countries much weaker than Britain will find themselves in borrowing from the Bank. In negotiating the American loan, Britain made it quite clear that under less favorable terms there could be no prospect of servicing and repayment. In stressing the need for favorable terms, Britain was not asking for more than her due, she was acting as a borrower conscious of the responsibilities she is undertaking. We must be careful lest we be imposing obligations which in the nature of things are impossible of fulfilment. I wish to state once more my conviction that the Bank's standing and success will depend much more on the close and competent scrutiny and supervision which it will exercise in operating loans and on its efforts to lighten the burden of its borrowers than on the imposition of onerous obligations on these borrowers in the vain hope of showing a surplus at the end of a given period.

It is stated in the Report that "if, in the long run, the Bank would appear to amass large surpluses, not considered fully necessary for the covering of risks, it should be up to the Bank to decide whether a dividend should be paid or a rebate should be given to the borrowers." In my view, the Committee has taken too optimistic a view of world economic prospects in the next decade. Personally, I feel that the world will be fortunate indeed if it manages to weather the storms ahead without a major crisis or even a collapse. During the coming critical decade, there will simply be no margin for the accumulation of dollar surpluses to be obtained from countries struggling to regain their economic equilibrium under most difficult conditions.

As regards the payment of dividends, I can hardly imagine that the countries which have taken the initiative in establishing the Bank and have provided the bulk of its funds are thinking in terms of dividends. Their whole efforts and policies seem to be bent on helping to solve the existing economic disequilibrium in the world, not on intensifying them. This, I believe, is true also of their attitude towards the unpaid part of their contribution. I can hardly imagine that in making that contribution they expected it to be considered only as "a last resort". In aiming to become financially independent of that contribution, the Bank may be trying to do the impossible.

My conclusion is that there should be no margin between the rate of interest paid by the Bank on its borrowed funds and the rate of interest charged by the Bank on its loans and that interest should be charged from the date of disbursement and not from the date of commitment.

I am convinced that the recommendation of the Committee that interest should be charged from the date of commitment requires serious reconsideration. This recommendation would impose on the borrowing countries a burden which they should not, in fairness, be asked to bear. If these countries unduly delay the utilization of the funds allocated to them by the Bank, the Bank will always be able to protect itself against losses by threatening to cancel or even cancelling its commitments. The borrowing countries, on the other hand, will have no protection against undue delays occasioned by the Bank itself. It is clear that with the existing desire to increase earnings, the authorities of the Bank will tend to make the earliest possible commitments. At the same time, there is no guarantee that the world supply position, or even the Bank's processing and supervision of the loans, will not mean long and costly delays to the borrowing countries. The processing of loans is bound, in any case, to be a slow operation. If it is the borrowing countries that will have to bear the burden of delay there is no guarantee that the processing of loans will not be unduly slow.

It should be the responsibility of the Bank to make the gap between commitments and disbursements as short as possible. This the Bank can do by exercising sound judgment in the making of commitments and by expediting the processing of its loans. (This, incidentally, would speed up world recovery.) The cost of the inevitable gap between commitments and disbursements can be amply met from the interest charged on funds arising from direct contributions and is a cost for which the Bank, not the borrowing countries, should be responsible if it is to be kept to a minimum.

The objection is made in the Report, that if interest is charged from the date of disbursement, it would be difficult for the Bank to fix, at the date of the granting of the loan, a rate of interest not to be changed during the currency of the loan. This assumes that loans will be made before the Bank's securities have been tested on the market. While it may be necessary to grant small advances from the Bank's own funds, it is difficult to see how the Bank can enter into major commitments without previously testing the markets that will provide the bulk of its funds. I feel, therefore, that the objection raised by the Committee is not decisive and can be met through temporary arrangements.

Article III, Section 1 (b) of the Articles of Agreement provide that the Bank, in determining the conditions and terms of loans made to countries whose metropolitan territories have suffered great devastation from enemy occupation or hostilities, shall pay special regard to lightening the financial burden and expediting the completion of the restoration and reconstruction of their economy.

Reference to this provision has been made in several reports of the Bank's Committees, but no means for implementing it have as yet been suggested to the Board. On the other hand, the recommendation that interest be charged from the date of commitment can hardly be considered as calculated to lighten the burden of borrowing countries.

In conclusion, I should like to state once more my conviction that the effort by the Bank to accumulate in the next decade large dollar surpluses, obtained by imposing additional burdens on the borrowing countries, is bound to fail because it will be against the realities of the world economic situation. I very much fear that these surpluses will largely remain on paper and the attempt to realize them will only tend to aggravate the already difficult problem of achieving balanced international payments.