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MEMORANDUM to the President

FROM: John J. McCloy

SUBJECT: United States Foreign Lending and the International Bank.

At our conference on December 20th you suggested that the time had come for an overall review of the foreign lending policies of the United States, in order that an orderly program might be worked out and clear lines of demarcation drawn between the fields of operations of the ECA, the Export-Import Bank and the International Bank.

The need for such a review of policy and delineation of functions is especially urgent due to two factors: first, the necessity for determining the form in which ECA appropriations should be sought from Congress for the second year of ERP; and, second, the proposal which has been made by the Chairman of the Export-Import Bank that the lending limitation of that Bank (now \$3,500,000,000) be substantially increased.

I am presenting this memorandum in order to give you my views with regard to the lending policies of the United States Government as they may affect the operations of the International Bank. You will understand, of course, that the views here expressed are my own and have not been discussed with or approved by the Bank's Executive Directors.

I. BASIC POLICIES

A. A Clear Distinction Should be Made Between Loans and Grants.

In considering any foreign economic assistance program, a clear distinction

should be made between loans and grants. Loans should be made only where there is sound economic justification for the loan and reasonable prospects of repayment exist. All other foreign economic assistance should be in the form of grants.

It is clearly not wise to saddle a country with loans which it cannot repay. In the end that will lead only to default, impairment of the borrower's credit standing and international ill-will. These were the results of the unsound international lending in the 1920's. Many countries are still suffering from the unfortunate consequences of their over-borrowing in those years.

Furthermore, unless the United States Government is to continue indefinitely as the principal source of international capital, steps must be taken to restore the confidence of private investors in foreign investments. This requires not only building up the economic capacities of recipient countries to meet their foreign obligations but also generating a greater regard for those obligations and the will to meet them. It would be directly contrary to these objectives for loans to be made on other than a sound economic basis.

In particular, loans to achieve immediate political or strategic objectives should, to the extent possible, be avoided. Such loans are usually looked upon by the borrowing countries as in the nature of grants given in return for advantages to the lender and thus pressure for their service is always resented because it is regarded as the exaction of a double payment. Witness the inter-governmental loans that were made during and after the First World War. Few of them were repaid and the question of their repayment was the subject of international political recrimination throughout the inter-war period. As

a result of this lesson, United States financial help during World War II was furnished in the form of Lend-Lease rather than by way of direct loans, thereby avoiding many of the unfortunate consequences of the earlier experience. However, if during the present period of economic rehabilitation, the United States should again revert to a program of large-scale inter-governmental lending, the inevitable result would be renewed defaults, hostility to the United States as the creditor nation, and a drying up of other channels of international investment. There is danger, too, that these after-effects of such a lending program would result in a resurgence of isolationist sentiment in many parts of this country.

I do not want to be understood as suggesting that financial assistance should not be made available by the United States to other countries, whether for political, economic or humanitarian reasons, in excess of the relatively limited amount of sound loans which can be absorbed by those countries. I urge only that such additional assistance be in the form of grants rather than in the form of illusory loans, and that whatever grants be considered within the resources of the United States be not so large as to deprive the recipient countries of incentive to exert their own efforts to the full. It should not be difficult to convince anyone that, in the long run, it will be less costly to the American taxpayer to make avowed grants than to make loans which cannot be repaid but which will have the result of discouraging investment from other sources. And certainly the advantage to the United States of following this course, from the standpoint of international political relationships, is readily demonstrable.

B. The International Bank Should be Regarded by the United States as the Principal Public Source for Long-Term International Investment. The International Bank was established at United States' initiative to serve as the principal medium for the international investment of capital for reconstruction and development projects unable to attract private capital on reasonable terms. There are, in my judgment, many and cogent reasons why the United States should maintain and indeed strengthen its support of the International Bank.

From a financial standpoint, the United States has a large stake in the International Bank (\$3,175,000,000 or 38% of its capital) and a real interest in seeing that the Bank accomplishes its purposes. When the United States makes a loan to another country, it assumes the whole risk of loss. On the other hand, when the International Bank makes a loan, even with funds supplied by the United States, 46 other countries share in the risk. Similarly, when a country to which the United States has made a loan defaults, the matter becomes a political issue between them, while in the case of a default on a Bank loan, there are 46 other countries which have a direct interest in seeing the default cured.

Because it is an international organization, the Bank is in a better position than any United States Government agency to resist political pressures and to allocate its resources on a sound economic basis. For the same reason, the Bank can and does supervise the use of the proceeds of its loans in a manner which it would be difficult for any national agency to emulate. In many cases, too, the Bank insists, as a condition of its loan, that the borrower concurrently undertake a program of economic and financial reforms

which are necessary to assure that the loan will be both productive and safe; in the case of loans by the United States Government, on the other hand, it is often impracticable or impolitic to insist on comparable conditions. Finally, and perhaps most important, to the extent that loans are made by the International Bank rather than directly by the United States, the United States is relieved of both the burden and the odium of being creditor to the world.

As I have already indicated, I believe that nothing would be more productive of ill-will towards the United States than to have the other nations of the world over a long period of time regard the United States Government as their principal source of foreign capital. Under such circumstances, those receiving financial aid would not regard it as a favor but as a matter of right, while those who received nothing, or less than they thought they were entitled to, would consider the United States guilty of unfriendly discrimination. There would be no end to the calls made upon the United States and, should the United States itself decide to halt the program, it would be confronted by out-cries from every side. The pressures now being exerted for "Marshall Plans" for Latin America and for the Far East bear witness to this. To the extent that the International Bank rather than a United States Government agency is the instrument of investment, these consequences can be avoided.

The arguments usually advanced by those who advocate a resumption by the United States Government of the lending functions which are now the responsibility of the International Bank are that

the Bank does not have sufficient resources to make the necessary loans, that the Bank's management has followed too "tough" a policy with respect to granting loans and as a result has accomplished little; and that the Bank's loan charges are too high. In my opinion none of these arguments is well-founded.

So far as concerns the charge that the International Bank does not have sufficient resources to discharge its responsibilities, the fact is that the Bank has never refused to finance any sound project presented to it by reason of lack of funds, and I can foresee no such case arising within the next few years at least. Two years ago, it is true, the Bank's ability to sell substantial amounts of its bonds in the private investment market was questionable, both because of widespread ignorance on the part of investors concerning the Bank and the security behind its obligations and also because of legal restrictions on the authority of institutional investors to purchase the Bank's bonds. However, as a result of strenuous efforts on the part both of the management of the Bank and of the United States Executive Director, the situation has by now been entirely altered. Legislative or administrative action in almost all of the more important states has served to open the institutional market. The credit standing of the Bank has been firmly established and there is a substantial unsatisfied demand for its bonds. Accordingly, although the Bank has no immediate need to resort to the market because it still has approximately half a billion dollars

in its till, I feel confident that, as occasion arises, it can readily raise additional funds by the sale of its bonds, at least up to the amount of the United States guarantee (\$2,540,000,000). Assuming continuation of ERP on an appropriate scale, this should certainly provide the Bank with the necessary resources for all the projects (other than those within the ERP program) which are likely to be ready for financing within the next few years and which can properly be financed on a loan basis. An annual lending program of say, \$500,000,000, if loans in that amount can be justified, should certainly not be beyond the capacity of the Bank for a few years at least.

The argument sometimes made that the Bank has accomplished little and that this is because the Bank's management has followed too "tough" a lending policy is, in my judgment, even wider of the mark. The management of the Bank has, to be sure, in accordance with the provisions of its Articles, attempted to follow sound business practices and procedures in operating the Bank; it has been "tough" only in the sense of resisting political pressures and refusing to be hurried into ill-considered loans. It has also been hard-headed in insisting that it will make its funds available only for projects which are well-prepared and well-planned and that, where necessary, the borrowing country must, concurrently with the granting of the loan, take appropriate steps to remedy economic and monetary conditions which would otherwise tend to defeat the purposes of the loan. These policies I regard as eminently sound, from the standpoint of the

Bank's members as well as of the Bank, even though they have prevented the Bank from making large investments in a short period of time. As a result of these policies, substantial progress is being made in a number of countries towards creating a firm economic base for further development, formulating an integrated and well-balanced development program and drawing up realistic plans for projects within such a program. In this manner the Bank has, I believe, contributed more to the economic well-being of its members than would have been the case had it simply opened large lines of credit in their favor.

Not much need be said about the argument that the Bank's loan charges are too high. The rate of 4-1/2% now prevailing on long-term loans by the Bank is certainly not excessive for international lending, particularly since the prevailing domestic interest rate in the borrowing country is generally considerably higher. For similar loans, the Eximbank has normally charged about 3-1/2%. The difference is largely one of the 1% commission which the International Bank is required by its Articles to charge for the purpose of creating a special reserve to meet the Bank's obligations in the event of default on its loans. This special reserve serves as a protection to all of the members of the Bank in their capacity as guarantors of the Bank's obligations.

There are those who would contrast the Bank's rates with the 2-1/2% charged on ECA loans. But that 2-1/2% rate is an artificially low one, designed to meet a particular situation. While



it may cover the direct cost of money to the United States, it does not provide any margin to cover losses which may be incurred on such loans. Thus, in effect, the United States taxpayers are assuming a substantial risk of loss without any margin to cover such risk. This is scarcely a sound basis for long-term international investment.

To those who urge that the United States should adopt a "generous" lending policy in order to strengthen its hand in international negotiations, the unhappy history of inter-governmental loans made for political purposes provides ample reply.

C. Competition Between the International Bank and United States Government Lending Agencies Should be Avoided. It is clearly within the power of the United States Government, should it wish to follow such a policy, to put the International Bank out of business by making available to the Eximbank, or some other national agency, funds for the purpose of enabling it to make loans of the same type as are made by the International Bank but on more favorable terms to the borrowers than the International Bank can offer. Certainly no prospective borrower would look to the Bank for funds at 4-1/2% when it could secure them from the United States at 3-1/2% or less. The situation would not be greatly altered even were the United States to adopt a policy that it would not make loans which the International Bank was willing and able to make. In the first place, every country desiring a loan would find it expedient to place one obstacle after another in the way of the International Bank granting a loan. There have already been indications of this in the case of

certain countries which commenced negotiations with the International Bank and thereafter, when they saw a chance of securing the desired financing from ECA or the Eximbank, abandoned or delayed such negotiations. In the second place, even if this difficulty could be overcome, it would be productive of confusion and ill-will to have a United States agency and the International Bank making loans for similar purposes to different countries at different rates of interest and on different terms. Those countries which were forced to resort to the International Bank would at best be reluctant and consequently unsatisfactory borrowers.

It is a fundamental mistake, therefore, to think that if the United States should make substantial additional funds available for long-term reconstruction and development loans, such loans would simply supplement International Bank investments. In fact, they would supplant International Bank loans and would in all probability force the International Bank largely to curtail, or perhaps even to suspend, its operations.

I make this point so strongly because, in a letter dated November 24, 1948, addressed to the Chairman of the National Advisory Council on International Monetary and Financial Problems, the Chairman of the Export-Import Bank has suggested that the lending limitation of that Bank (now \$3,500,000,000) be substantially increased. This suggestion has been made even though, at the present time, the unused lending authority of the Export-Import Bank amounts to approximately one billion dollars.

There can be little doubt that acceptance of the Eximbank's proposal would be interpreted as meaning that that Bank was reentering the field of long-term reconstruction and development loans from which it largely withdrew two years ago when the International Bank began operations. Indeed, the Chairman of the Eximbank refers in support of his proposal to the "need of the Latin American countries for further developmental loans". It should also be noted that the present uncommitted lending capacity of the Eximbank is more than 177% of the total net new funds committed by that Bank in the last two years, and more than 14 times the total net amount committed by it during that period for Latin American countries.\* It is obvious, therefore, that the Eximbank has no present need for an increase in its lending authority except on the assumption that it is to expand its activities into fields now the responsibility of the International Bank. Accordingly, decision on the Eximbank's proposal must be made

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\* According to the Eximbank's semi-annual report for the half year ended June 30, 1948, during the two fiscal years ended on that date:  
(In thousands of dollars)

Total new credits authorized to all countries were	\$ 744,803
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Total repayments of loans were	181,855
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New Funds committed were	\$ 562,948
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During the same period, Eximbank's operations in Latin American countries were as follows:

Total new credits authorized	(In Thousands of dollars) \$ 119,573
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Total repayments of loans	51,136
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Net new funds committed	\$ 68,437
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in full realization that, if adopted, it would decisively affect the continued vitality of the International Bank.

## II. PRACTICAL CONCLUSIONS

If the views above expressed are accepted as sound, there are a number of practical conclusions which may be drawn:

A. European Recovery Program. Many of the countries participating in the European Recovery Program, including those which were allocated over 75% of the total ECA assistance during the first year of ERP, are in critical financial condition and accordingly are in no position to assume substantial additional dollar indebtedness. It seems clear, therefore, that, except in the case of those ERP countries which are able to assume real obligations which they are expected to repay, ECA assistance should be entirely on a grant basis.

In the case of certain of the ERP countries, it may be reasonable to expect repayment of all or a substantial part of ECA aid. To meet such cases, the Administrator should have discretionary authority to provide ECA assistance in the form of loans in situations where he finds such action to be economically justified. Such loans should, however, not be for such a long period of time, or at such a low rate of interest, as to partake of the character of grants. They would amount to only a small part of the total ECA assistance.

If ECA assistance is provided in the form suggested, there may not be many approaches to the International Bank from the ERP countries, at least until towards the end of the ERP period. However, to the extent that those countries do apply for Bank assistance and their capacity to assume further debt has not been exhausted by ECA loans, the Bank may be able usefully to supplement ERP by financing

some of the longer-term projects.

B. Development Loans. It is clear that neither the United States Government nor any other government can or should permanently subsidize the economic development of any foreign country. The economic purpose of providing financial assistance to another country should always be, as it is in the case of ERP, to enable the recipient nation to establish its economy on a sound basis so that, within a reasonable period, it may go forward without extraordinary foreign aid. It is also clear that, whatever the amount of capital which can ultimately be employed to advance the economic development of any particular country, both economic and technical considerations impose fairly definite limits on the rapidity with which capital can be usefully absorbed for that purpose over any given period of time. The amount of economic development which can be properly carried on with foreign loans is even more restricted.

Despite these considerations, there is an increasing tendency on the part of many countries to look to foreign governments, and especially to the United States, and to international agencies for the financing of their economic development, without adequate appreciation of the extent to which their own efforts are necessary if such financing is in the end to accomplish its purpose. The result is, of course, a continual pressure on the part of those countries for foreign financial assistance in amounts far beyond their capacity to use to real economic advantage.

Obviously the United States cannot satisfy all the claims for assistance which are being put forward. If it tried to do so, the result would be the generation of additional claims in larger amounts and a postponement of the day when the recipient countries will be

able to rely on their own resources and to attract private investment. Moreover, if long continued, the effects of such a program on the United States economy would be considerable.

The United States through its large capital subscription to the International Bank has already made available substantial sums for development needs. In my judgment, it is well within the capacity of the International Bank to finance all development projects of its member countries which will be ready for financing in the next few years and which can properly be financed with foreign loans. Accordingly, it is difficult to see any economic justification for the United States now engaging in a new and enlarged program of international development financing.

There are, of course, some types of development loans of interest to the United States which the International Bank, because of the provisions of its Articles of Agreement, cannot make. It cannot, for example, make loans to non-members or loans to American private enterprises operating abroad without the guarantee of the government of the country where the enterprise is located. However, the Eximbank already has available sufficient resources with which to make loans in such cases.\*

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\* Such loans should clearly not be made by Eximbank on terms more favorable to the borrowers than those which the International Bank can offer for similar loans. Otherwise the United States would in effect be putting a premium on non-membership in the International Bank or, in the case of loans without a government guarantee, be destroying the incentive of foreign governments to lend their support to development projects.

I would add that the long-run objective of United States policy in the field of development financing should be the encouragement of private international investment, especially equity investment. From the standpoint of the United States, such investment is beneficial not only because it avoids a burden on the Treasury but also because it avoids many of the political difficulties of inter-governmental loans. And from the standpoint of the recipient country, it has the advantage of bringing with it not only capital but also know-how and technical and managerial skills and, in addition, furnishes opportunities for developing local know-how and skills.

C. Guarantees. The Economic Cooperation Act contains a provision giving ECA limited authority to guarantee the convertibility into dollars of foreign currencies resulting from private United States investments in the ERP countries. The Chairman of the Eximbank has suggested that a broader authority along the same lines, and without geographical limitation, be vested in the Eximbank.

The International Bank has for some time been giving careful consideration to the possibility of its making similar guarantees. It is satisfied that it has the power to do so, at least for investments in the form of loans. The proposal, however, presents a number of complicated problems which it would take too long to discuss in detail in this memorandum. Suffice it to say that there has not yet been presented to the Bank a request for such a guarantee in respect of any project which the Bank considered that it would be warranted in granting.

It may well be that the Eximbank could do some useful pioneering in this field and at the same time encourage foreign investment by private interests in the United States.

D. Latin America. I recognize that one of the important political objectives of the United States today is to maintain and strengthen its position in Latin America. For reasons I have already stated, I do not believe that additional loans by the United States to the Latin American countries would, in the long run, advance this objective. Even governmental grants, as we have seen in certain cases under the ECA, may only serve to stir animosities.

There is, however, a field in which I believe the United States could make a sustained contribution to the Latin American countries which would be conducive of political good-will towards the United States and at the same time be of substantial economic and social benefit. I have in mind the establishment of some sort of Foundation to be administered avowedly as a humanitarian measure for the advancement of science, agriculture, health, general education, technical training and related subjects, without any thought of direct repayment for the benefits obtained. Such a Foundation would be particularly appropriate for the Latin American area but it might be more extensive.

In my judgment such a Foundation should be administered very much along the lines of the Rockefeller Foundation (though with less emphasis on the academic) with a well-paid expert staff recruited primarily, not from government sources, but from private scientific educational, industrial, business and labor fields. Its policies



should be developed by a directorate composed of large-minded men, again primarily from private life. The sums made available should be at the disposal of this group without any thought of control by the Government as such, though some members of the United States Government might be represented on the Board. The administration should be exacting in terms of results to be obtained but it should be non-political and objective.

In the Latin American area the problems of sanitation, disease prevention, medical services, agricultural methods, vocational training, technical schools, soil erosion and a number of others of like character are common and acute. Properly administered such a Foundation could deal with these problems in a substantial way and thereby help to provide a real base for economic development which could then be financed far more hopefully than present conditions permit. The amount of money that would be necessary for such a Foundation is relatively unimportant. When one thinks that in 1910 the Rockefeller Foundation had \$500,000,000 with which to stimulate research, science, education, health, etc. for the entire world and has only spent that much money since that time, one can realize that no enormous sums are necessary to achieve widespread and deeply beneficent results. What really counts is whether the funds made available are administered in a business-like and imaginative manner.

Some have compared the good-will that might emanate from such a Foundation to that which the United States achieved on the diversion of the Boxer indemnity or indeed that which the Rockefeller Foundation has achieved throughout the world, but, whether it has these results or not, the least that can be said of it is that it will not create

ill-will and at the same time it will almost certainly produce a base on which the low standards of health, education and per capita income can be raised. I believe the possibilities of developing such a Foundation as this ought to be seriously studied in the short time that remains before the Buenos Aires meeting takes place.

Another matter which I think merits immediate study is the steps that might be taken to complete within a shorter time than is now contemplated the so-called "Inter-American Highway". It might be possible to arrange that, in return for the United States making available funds to complete construction of this highway, the local authorities will agree to cooperate in maintaining it. I do not know enough about the history of the project to gauge the practicability of this suggestion. I do know that a well-constructed and well-maintained trunk road from Mexico through to western South America would result in real development. At least so far as the Central American area is concerned I would think that this would be a definite tangible project, capable of completion within a limited time, of great economic value to the countries concerned and of some strategic value to the United States.

I see no need for grants of the "Marshall Plan" type for Latin America and, as I have already indicated, I firmly believe that existing public lending agencies can provide all the debt financing that the area can properly absorb at least within the next few years.

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