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Transcript of interview with

Robert W. Cavanaugh

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Interview with Mr. Robert Cavanaugh

By Robert Oliver July 25, 1961

Interview No. 1

Q: Would you tell your name and a little bit about how you came to the Bank and what you've done here?

Cavanaugh: My name is Bob Cavanaugh and before I came to the Bank I worked entirely for the United States Government. I started off with nine years going around the country with the Federal Deposit Insurance Corporation, closing banks and paying off depositors. I hope this has no relation to my reason for coming to the World Bank.

Then during the war I transferred to the Office of the Alien Property Custodian for two years, and then was in the Foreign Economic Administration as chief for land-lease fiscal operations.

After the war I went to the State Department for a year to work on land-lease settlement negotiations, and then went to the Treasury Department for the best part of a year, to help set up the liquidation accounts on land lease. A lot of this was on a cash basis, and we billed and collected a lot of foreign exchange during the land-lease days. So altogether the banking activities I had plus the foreign exchange and foreign contacts that I made it a natural for me to be interested in the World Bank.

I came here in March of '47 as chief of the Finance Division and carried on in this job actually until two years ago, when I was made Treasurer. The Finance Division was and is a part of the Treasurer's Office, dealing primarily with the borrowing of funds, with the financial policy operations of the Bank, with the investment of the Bank's liquid funds and with the accounts.

Q: Who are the various people who had been treasurer of the Bank before you became treasurer yourself?

Cavanaugh: Well, the first treasurer, who was here when I came, was Mr. Crena de Iongh. He's a Dutchman, who had had a lot of banking experience in Holland and was a member of the Dutch delegation to Bretton Woods. When he retired Henry Reilly became the treasurer. Then about two years ago, unfortunately, Henry died.

Q: I wonder if you would just say a little bit about the relation of the Treasurer's department to the other operating departments in the Bank, particularly with respect to the early years when working parties were being used in connection with loan negotiations.

Cavanaugh: The Treasurer's Office naturally works with every other department in the Bank on the funds side of the Bank's operations. The Treasurer's office works with the Secretary's Office and Legal Department on the membership side of the picture. We're responsible for the collection and financial relationships with members. We see to it that the capital is paid in and is properly deposited and taken care of. And on the 18 percent portion of the capital we're responsible to see that it's in liquid form when we need it for disbursements. On the borrowing, the selling of our bonds, we work with the Marketing

Department and the Legal Department in arranging for all our bond issues. We advise the President to start with as to when borrowings are necessary. We put in our recommendations as to what the term of the bonds should be.

Q: I wonder if, in connection with this question, the terms of the disbursement of funds, when the Bank is actually making loans, I take it that much of this policy was hammered out at the Bank even before the first French loan was made.

Cavanaugh: The policy of disbursement, you mean?

Q: Yes, and the charges, interest rates.

Cavanaugh: Well, on the question of the lending of funds it certainly does tie in with the borrowing activities. In the early days it was true that many of our potential borrowers could afford to pay back funds but could not afford to pay back hard foreign exchange. In those days dollars were really the only convertible currency, and a number of our borrowers had difficulties in making dollar repayments, or we assumed that they would if we tried to limit all of our lending to dollars. This made the 18 percent portion of the capital very important, and we started early and continued a succession of drives to encourage our members to release the 18 percent portion so that we would have it available to lend to our borrowers who then could afford to borrow more because they were able to pay back in currencies that were not as hard. There were relative degrees of hardness or softness on the other side. Uruguay, for example, is one of the few South American countries who conducts most of its trade with Europe. It was earning a lot of funds in European currencies but was earning very few dollars. Therefore, it was much better for Uruguay to borrow softer European currencies that were non-convertible to them than to borrow dollars.

We were able to supply some of our borrowers' needs with our 18 percent capital but not too much. And, therefore, it made it very advantageous, both from the borrower's standpoint and from the Bank's, as an international organization, to find the capital markets of Europe opening up to us.

We started our European borrowing operations in London. Of course, each of the individual European capital markets are small in relation to the United States' capital market. It's easier for us to borrow a hundred or 150 million dollars in this country, but in Switzerland a bond issue of 20 million dollars is large. In the U.K. a foreign borrowing of 10 to 20 million dollars is large. In Germany there's very limited market for foreign issues. In Holland, there again we're speaking in the neighborhood of 15 to 20 million. In Belgium it's 10 to 15 million dollars at a time. Even in Canada, which is closer to us, whose currency has been practically as hard as the United States dollar throughout our history and at times has been more in demand than the United States dollars, a bond issue of 20 million to 25 million is a big bond issue. In Italy, where we just had our first bond issue, again you're limited very greatly by the fact that people are not accustomed to buying foreign bonds and so an issue of 20 or 25 million is, again, a big issue. So that each one of these in itself is small, and the governments of these countries have been very reluctant through most of the history of the Bank to permit foreign borrowing because they needed the money for their own internal needs. Probably the three factors that affect the foreign market, as far as we're concerned, are first, that they're small, as we've talked about it. Secondly, the governments of those countries have a definite control over what the foreign borrowing is going to be. And, although they're sympathetic and anxious to have the World Bank among the borrowers who are allowed into their markets, Switzerland usually lets us in once, sometimes twice, a year. In Holland we've had only three issues. In the United Kingdom we've had three issues. Canada, again, limits the amount that foreigners, including the World Bank, can borrow. All of them do this.

And the third factor that limits us is the question of interest rates, and most of the period of the Bank's existence we've faced higher interest rates abroad than in the United States. Canada has consistently been higher. All countries, I would say, except Switzerland and Holland, have been consistently higher.

We're willing to pay a little more to borrow abroad merely to keep the various markets open, and we're willing to pay something for the fact that we are an international organization, and this is a step in broadening the understanding of the Bank by borrowing in all of these various markets. But there is a limit, naturally, to how much more you can pay. We've normally thought of something in the neighborhood of one percent that we're willing to pay for a foreign issue over what we would pay for a United States issue.

Q: Did I understand you to say that the Bank became interested in selling bonds abroad primarily because it wanted to have these currencies to make loans?

Cavanaugh: I think that's certainly one of the primary factors. We could aid our borrowers with furnishing them with a non-dollar or a non-convertible currency. Secondly, it's the international aspect of the Bank, and it means that we should try to borrow in the various markets. And, thirdly, the fact that we're borrowing in these markets makes it more easy to borrow in the United States market and makes it less expensive. The more markets we have to borrow in, the less strain we're going to be on any one of them, and the more advantageous the terms of the lending will be towards us.

Q: Did I understand you to say that the 18 percent subscriptions were not available even at the time when the Bank started borrowing in some of those markets?

Cavanaugh: Yes, that's true. The United States, of course, released its entire 18 percent immediately. The other countries--well, as you know the articles provide that every country has a right to withhold the use of its 18 percent funds for lending. And it was anticipated, when the articles were drafted, that some countries from time to time would be unable to permit an export of capital funds from their markets. So, this restriction was put on the Bank, that in order to use these funds it had to get the permission of the government whose currency was involved.

In the beginning of the Bank's operations most countries were in the throes of trying to reconstruct their own economies and couldn't afford to export capital. So, this has been a period of 15 years--and we're still not through--of getting the 18 percent available. Most of the countries who started to release 18 percent funds did so in small amounts. And, initially, most of them would make it available only for purchases that were being made by our borrowers in that country. They would not make it available on a convertible basis. Now, we've got about 80 percent of our 18 percent funds released, and we feel we've accomplished a great deal.

Q: I thought the articles of agreement said something about no government was supposed to put any restrictions on the use of their currency once they'd been made available to the Bank.

Cavanaugh: I think you're referring to the tied-lending aspect and this really is not a violation of the tied-lending aspect of the articles. The borrower is still free to buy the goods wherever he wants to buy them and we insist that he do go through the steps of international competitive bidding, so that he will get the best bid in all the circumstances. But if you have six borrowers who go through the competitive bidding mechanics and, thus, arrive at a point where each of them is buying some goods from, say, another six other different countries, if the six countries which these borrowers are buying goods in each say that to the extent any borrower buys goods in its country, its territories, they will make their 18 percent funds available, it does give us a possibility of using them without restricting our borrower as to where he can buy.

Also, it is true that when we knew that we had certain funds for lending, we were able to make use of those in loans not by telling the borrower where he had to buy but in a number of cases borrowers would have a project which required, say, a hundred million dollars of foreign exchange. If we lent 50 million against that program or project, it meant we had a chance to pick out of the total program the certain goods that we were going to finance. And it did lend us actually in certain cases, such as in the case of India, to picking up goods they were buying in Japan because we had Japanese yen available for lending if goods were bought in Japan. And so, instead of picking up something India might have been buying in the United States, we picked up goods they bought in Japan.

This means that there is some fiction in any statistics you see as to where our borrowers bought the goods with the money we made available to them. These figures are statistics to start with; they overlook many factors, such as we might record India as having purchased something from France, and this is true. The goods did come from France, but France might have imported 50 or 60 percent of the component parts of this product that they then sold to India. So, it's not quite exact to say that this particular purchase by India was made in France. And on top of this, you get the factors that I was just mentioning, that we sometimes picked up a part of the cost of goods coming from a particular country merely to be able to utilize funds that we had readily available, which, again, some throws some margin of error on any statistics you would find as to where goods were bought by our borrowers.

Q: Has there been occasions when member countries have simply refused to make their currencies available to the Bank, even when it was known the money was going to be used for direct purchase in that country?

Cavanaugh: Yes, we've certainly had many periods when we knew where a large amount of the goods were going to come from and the country in whose territories the purchases were being made was not willing and perhaps was not able at that moment to make the funds available. But this, obviously, was a factor that we could use in trying to obtain the releases from our members. If we could tell the U.K. that we had made a loan, and that the contracts had been placed in the U.K., therefore we felt it was more reasonable for them to make available their 18 percent funds, this obviously was an argument they were willing to accept as being valid. Whereas they had an internal ability to supply the funds, their primary concern was that we would convert them, say, into dollars and thus drain dollars out of their reserves.

Q: I suppose they would have been happiest of all though if you had loaned dollars and the dollars would have been used to buy the goods in the U.K.

Cavanaugh: Yes, there's no question that they would have benefitted most by that sort of operations, but the U.K., as well as most of our members, freely admit that they have an obligation to make their 18 percent funds available, and it's more a question of timing, when are they able to do so, than whether they have an obligation. A lot of our underdeveloped countries do argue that if we're lending them money that's proof in itself that they aren't able to export capital and, therefore, should not make their 18 percent funds available. Now, this we don't accept as a valid argument because if you look at the economic history of any country, you'll find that many countries are simultaneously exporting and importing capital. And this is true certainly of all the developed countries, I would say, and true of many of the underdeveloped countries. So, it's a matter of degree.

Q: I wonder if it would be a good idea to make clear fairly early in this tape that the Bank does not necessarily loan the currency which it actually spent.

Cavanaugh: I assume by that you mean that a borrower may buy goods in France and we might take some of our deutschmark and finance the purchase, and therefore the borrower has to repay in deutschmark. I think this is certainly an important fact which should be recorded. The Bank, when it developed its loan regulations and loan policies, felt of course that it had to give a borrower the currency it needed to buy the goods. This is a primary prerequisite to any lending. If the borrower doesn't get the currency it needs to buy the goods, why, then the loan is going to do them no good.

We have always provided in our loan regulations that the borrower would get one of two things: He'd get the currency he needed to buy the goods or the currency in which the loan was denominated. Most loans are denominated in dollars and that meant that the Bank has the choice of giving the borrower the currency of the country in which the borrower bought the goods or giving dollars. Since dollars have always been convertible this created no problem for the Bank, plus when you bear in mind the fact that the Bank has always had more dollars than any other currency.

Now, since we needed to give the borrower a currency he could use to buy the goods, and since most currencies we had were not convertible, this created a complication to us. And we had to go through the mechanics which we discussed earlier of picking up goods in certain countries where we had releases. However, our dollars have always been convertible and as of today, and for quite a few years now, most of our European currency holdings have been convertible.

We went through all the pros and cons in the beginning as to what should a borrower repay. There were those who wanted them to repay the currency he received. There were those who wanted him to repay in gold. There were those who wanted to have everything in dollars. And then there were those who said let's try to keep our currencies intact and avoid exchange risks in doing so.

Now, the 18 percent funds--well, before going into the exchange-risk side of it, I think we should complete the picture of the policy that was adopted. That is, the borrower is required to pay us back the currency we use to acquire the currency we give him. In other words, if a borrower buys in France and needs French francs to cover the cost of the goods, we give the borrower French francs. But we may start with deutschmark and buy French francs with deutschmarks as our holdings of funds at that moment makes it most advisable for the Bank to use deutschmark which we started with, and this policy gets into the decision that I mentioned primarily of avoiding the exchange risk. Those who wanted all borrowers to repay in gold were easily outvoted, as there weren't many who felt that was a wise move.

Q: You say outvoted. Do you mean this was a policy decision taken by the board of directors?

Cavanaugh: No, it didn't get that far. It was certainly discussed in the board of directors. All of these various alternatives were discussed. Since this is an international organization, it just wasn't appropriate, for example, that everything be repaid in dollars, although at that time dollars were the only convertible currency. In order to keep your assets intact, it seemed advisable to some people that this be done.

Now, this, of course, ran completely contrary as far as 10 percent funds were concerned; the articles prescribed that we'd have to recover 18 percent funds in the forms in which we loaned them. And this, in itself, created a need to adopt the policy of always getting repaid in the currency which you start with. The member has a right not only to say no to our lending 18 percent once, but every time we want to relend it, the member has the right to say yes or no. And this meant, to the extent of the 18 percent capital, we had to always get it back. Now, on profits and borrowed funds, you did not have this need specified in the articles. But if you borrowed dollars and let somebody repay that in, say, Italian lire, it meant the Bank would be taking an exchange risk. We had to pay back a bondholder in dollars and if we were receiving from our borrower Italian lire, it meant that we had to convert the Italian lire into dollars and thus take the risk that that amount of lire would not purchase the amount of dollars that you started with.

Q: The interesting aspect of this to me, though, is that the Bank decided fairly early that it itself was going to go into the exchange market to buy the currencies which were going to be actually spent, rather than just giving a loan of the currency that was to be repaid and letting the borrower himself go into the exchange market to buy the currencies he might need.

Cavanaugh: It is true we could have, in the example we were using, turned the deutschmark over to the borrower and let him buy the French francs, but we didn't do this for several reasons. We felt first that if Germany were making its funds available to us, either from capital or from borrowings we might have had in Germany, they would be entitled to some protection. And added to that, you have the fact that France, where the goods were being bought in the example we used, was throughout most of the history of the Bank having difficulties in maintaining its reserves and in maintaining the value of its currencies. If we had turned the deutschmark over to the borrower, the borrower then may or may not have bought French francs with them. The borrower may have had French francs through other trading that it had done with France, such as selling some goods in France, or it may have gone out into gray or black markets even to buy the French francs if it had to buy. But, in any event, it would wind up with the deutschmark in the first instance and would have freedom to do what it wanted with them.

We felt that France, being a member of the Bank, was entitled to our assistance in supplying it with foreign exchange, since it was delivering some goods to one of our borrowers, which might have otherwise sold for dollars, that if we had the deutschmark we should give them to the country supplying the goods, in this case France. This helped France in not having to worry about a larger amount of funds going into perhaps gray or black markets.

Q: So, it was of some help to the country actually supplying the goods in maintaining its exchange rate.

Cavanaugh: Yes, and was of no detriment to the borrower in view of the fact that he got the currency he needed to buy the goods. And some borrowers, as I've already mentioned, might already have had French francs and thus would have preferred that we give them the currency, the deutschmarks in this case, although primarily it was a question of our using dollars to buy the goods. And everybody was looking for dollars, so many of our borrowers wanted us to turn the dollars over to them even though they were buying in France.

Q: Was it considered that from the borrower's standpoint he might have been able to get the specific goods at even lower prices if he had been allowed to use the currency he was going to spend on the best terms he could get it?

Cavanaugh: This certainly was a factor. If a borrower could go into the black market and get the currency he needed at a lower rate, he would come out ahead assuming we gave him the same amount of dollars. We felt that this was not an advantage that the borrower should have when it was going to cost something to the member supplying the goods. Both sides were members, and we felt the deal should be conducted on completely legal basis. And even though some of these--it was possible in some cases to legally obtain a certain currency at a lower rate--we felt that the country supplying the goods was entitled to the foreign exchange that we would.

Q: Did you ever have any problems in this regard with countries having multiple exchange rates, knowing which rate you were going to use?

Cavanaugh: Yes, obviously, we've had many problems on the exchange-rate question. We normally would use the buying and selling rate consistent with par value. There have been many cases where par values didn't even exist, where the legal par that the country had declared was not accepted by the Monetary Fund and was not a rate that was used normally in trade. We naturally were unwilling to buy a smaller amount of the currency than somebody else would be able to buy with the same amount of dollars. However, we always worked it out with the country so that we did not have to hurt ourselves.

Now, since most of the goods that our borrowers buy have come from the Western European countries and from the United States and Canada--since they are the suppliers of the type of equipment our borrowers want to a large degree--these countries gave fewer examples of the multiple exchange rate problems than you would find among the underdeveloped countries.

Q: I suppose that in connection with the international competitive bidding you would have to know or decide who was the lowest bidder, not only what domestic currency was being quoted but also what the exchange rate involved was.

Cavanaugh: Well, normally, the goods, in the majority of cases, were quoted in the currency of the country supplying the goods. However, there were many exceptions to this, particularly during the early stages of the Bank. There were many countries in the world which supplied goods only against dollars. Certain government regulations provided that no manufacturer could export goods except for dollars, export them to certain areas of the country. They did have bilateral trade agreements with other countries. But our borrowers, being in the underdeveloped area primarily, were often required by the law of the country in which they were buying the goods to pay dollars. This we got around in many cases--well, in all cases where it was important to us--however, we did find, and we recommended to get around this, that the currency to be covered in the contract would be the currency of the country supplying the goods. And where the manufacturer--since he was producing something perhaps that was going to take a year or two or three years to produce--so that he wouldn't have to take the exchange risk against his own currency, we permitted him, and in fact recommended that the contract be written with the dollar-equivalent clause. So that if again you take a manufacturer in France who was supplying goods to one of our borrowers in South America, the contract would start off for payment in dollars, we would go and say we want this changed to payment in French francs but we'll agree that you can say that the amount of French francs to be paid will be the equivalent of the dollars that you started with. And it was certainly true that where a borrower was unwilling to pay dollars or unwilling to have the dollar-equivalent cost, he probably would have to pay more because the manufacturer wanted to be covered against a devaluation of his own currency.

Now, part of our reason for doing this was not only the cheapness of the price that you mentioned, but also the fact that it permitted us again to use the 18 percent funds. If all contracts, regardless of where the goods were being bought, had been expressed in dollars, then we could have used nothing but dollars because none of our other currencies, to speak of, were convertible into dollars. So that it was essential in our operations that the contracts be written in the currency.

Q: I should think that with this dollar clause involved there might be times when the borrower from the Bank would actually be paying more for a particular item than he would have paid if he had bought the item in some different country.

Cavanaugh: In a different country? No, I don't think so. I think the dollar clause actually made the goods cheaper all the way through. The borrower was free--in fact, we insisted that he have international competitive bidding--and we were able in all cases to have the contracts written the same regardless of where the supplier was located.

Q: While we're on the subject of currencies to be loaned, I wonder if you could say something else about the factors which determined which currencies the Bank does in fact loan. You mentioned the point that some borrowers did want to borrow dollars, say, because they didn't want to be obliged to repay dollars. But what other factors might the Bank take into account in determining which particular currencies it's going to lend?

Cavanaugh: Well, in the beginning we took great deal of pains to try to give the borrower a currency that it was going to be earning, and we tried not to put a dollar repayment liability on certain countries that just didn't earn dollars. This was the result of the fact that the currencies that the borrowers were earning were largely inconvertible to other than the dollar. Now, since convertibility is quite general and there are a lot of convertible currencies, this factor has ceased to be of great importance.

This meant that we could make more loans to countries than we could make originally because their total foreign exchange earnings are now available to them for repayment regardless of what currency they have to pay us since they can convert the currency they have into the currency they owe us. So that now the primary factor that we have been governing what the currency we use to finance the goods is based on the overall picture of interest rates throughout the world. We have currencies available to us in 18 percent funds which cost us nothing and where this interest rate...

We do not invest 18 percent funds. We theoretically could under the articles, could use them to buy bonds or deposit them in savings accounts or in otherwise interest-earning obligations. We feel that the articles imply that we should not do this, in that they provide for a substitution by the member of non-negotiable, non-interest bearing demand notes. However, some of our members have asked us to purchase their own government securities with 18 percent funds merely to help them to support their market for government securities, but we haven't done this. So that if we have--just, for example, United States dollars--some 18 percent dollars which we hadn't loaned yet and we had some borrowed funds and some profits, in dollars, the profits and the borrowed funds would be invested in interest-bearing government securities or otherwise invested. And naturally we would first use the 18 percent funds to disburse on loans since we're earning nothing from them.

Well, this follows right over into the question of when you have say dollars and deutschmark.

Q: Both paid-in 18 percent.

Cavanaugh: Well, say it's borrowed funds or profits, because if it's 18 percent funds it doesn't make any difference whether we use the dollars or the deutschmark; neither one is earning us anything and so the disbursement of one is just as good as the disbursement of the other. But say it's borrowed funds or profits and that we have them invested in a few countries. Well, in the United States today our average return is about three percent on our investments. In Germany now we can only get about two-and-a-quarter percent. So, obviously, it's in our best interest to use our deutschmark to finance a loan disbursement rather than dollars, because we will earn the same from the loan in either case and we naturally want to give up the cash or investment that earns us the least. And today in Canada we would get three-and-a-quarter to three-and-a-half percent, and in the U.K. we would get four-and-a-half to five percent on our short-term investments. In Holland we get very little and therefore would not want to hold guilders. In Switzerland the return is only about a quarter of one percent, and this is hard to find.

Q: So the Bank tries to lend the particular currency which is readily available but which is earning the Bank the least?

Cavanaugh: That's right. That's true today and it's the primary factor in deciding which currency we would use.

Q: And the least that you can earn on any currency is in the case of the 18 percent on which you're earning nothing.

Cavanaugh: That's right.

Q: So that, if at all possible, you try and lend 18 percent funds before you lend borrowed funds.

Cavanaugh: Right.

Q: Well, perhaps I didn't understand our earlier conversation quite. I thought that you said in some cases the Bank actually went out and borrowed currencies before those currencies had been made available as part of the 18 percent subscriptions.

Cavanaugh: I don't recall what you're referring to. It is true that we borrowed sterling before all of the 18 percent sterling was available. It was true that we borrowed deutschmark before al of it was available. But this was only because we couldn't get the 18 percent.

Q: It was still restricted.

Cavanaugh: Still restricted. But this didn't last long. I mean, we went into the U.K. bond market even though we had not received the release of all the 18 percent funds because we felt it was important to have a bond issue in the U.K., important to the Bank and the U.K. was willing to let us do it. And we did anticipate, however, that they would also make available their 18 percent.

Q: Well, if a member-borrower said that it was going to be very difficult for it to repay dollars but there were some 18 percent dollar subscriptions still available to the Bank, and no 18 percent subscriptions of any of the currencies the borrower really wanted to borrow, then what kind of dilemma would the Bank be in?

Cavanaugh: That certainly would be a dilemma if that existed; however, today this is not a problem. We do have, for example, the Indian rupee 18 percent funds that's being made available to us in the tranches, so much a year, and obviously anybody who is doing business with India, is selling goods to India for rupees, it would be to their advantage--since the rupee is not convertible--to have the loan repayable in rupees. However, this situation just doesn't exist, to my knowledge, anyplace, because the foreign exchange that any country is earning is usually a convertible currency today: it's earning dollars or sterling or French francs or deutschmark. Trade is just not conducted in these currencies of the underdeveloped countries. There's certainly some trade conducted in them but very little. Take trade between two South American countries; it would be conducted in dollars and not in the currency of either of the countries. And this is true with India and others. There's not too much trade conducted in rupees, that is foreign trade, so that none of our borrowers, therefore, have a chance to earn large amounts of the currencies of the underdeveloped countries or the inconvertible currencies. And, therefore, they have no advantage in our lending of those inconvertible currencies. And since the currencies they are earning are convertible, then it doesn't make any difference to them which currency we give because they can take the currency they have and convert it into the currency they owe us.

Q: I wonder if yet another factor might be the attitude of the investment market about loans made in the currency that they're particularly concerned with. I've heard, for example, that one of the reasons a number of currencies were loaned to Yugoslavia other than dollars was because there was a little concern that the people in New York might feel that this was not too good a use of dollars at the time.

Cavanaugh: I don't really think that was much of a factor. I think that primarily we had looked at the Yugoslav economy and its foreign trade and it was selling very little to the United States, and it, on the other hand, had already borrowed money from the Bank and owed dollars to others. And we felt that it just had no dollar-credit worthiness left. And so, when we made the loan to Yugoslavia it was only after we had examined the situation far enough to know that the goods they were going to need and that we were going to finance were going to be bought in Europe. And, therefore, we did have 18 percent releases available, in the various countries where they intended to buy the goods, and as a matter of fact in a few cases we went to the country where Yugoslavia expected to buy and asked them to make 18 percent releases available so that we could give them to Yugoslavia, and they did do this. So, we made Yugoslavia a loan and disbursed about 13 or 14 different currencies to them. This was a major problem, trying to sort this one out, so that we could make them the loan and have the currency available to meet the cost of the goods in currency they could afford to repay.

Q: What would the Bank's policy be with respect to the currency to be loaned, if it had half a dozen different currencies all freely available from 18 percent funds? Would then the ease of repayment in the particular currency be an overriding factor?

Cavanaugh: Yes, certainly if you had several different countries who had released 18 percent funds, it wouldn't make any difference to the Bank really which one it used and, therefore, it would use the one that was easiest for the borrower to repay. That's true.

Q: Was the Yugoslav loan the first loan made that was a non-dollar loan?

Cavanaugh: Well, it was the first loan made completely in non-dollars. I was going to say it was the only one; however, we have made a couple of loans that we denominated in sterling and another one that we denominated in deutschmark, merely because we knew at the time the loan was going to be made either that the goods were going to be bought entirely in the U.K. or in Germany or that we had sufficient of deutschmark or sterling to cover the loan. And this, again, is a factor that I hadn't mentioned before but which has led the Bank to denominate almost all of its loans as loans in various currencies equivalent to so many dollars rather than equivalent to any other currency, because dollars is the one currency we have in sufficient quantity to know that we could always cover the amount of the loan in that currency. If you make a 100-million-dollar loan you couldn't be sure that you would have sterling or deutschmark or any other currency in that quantity to finance the loan. So, this has really led us into what we call denominating the loan in dollars, although specifically a loan made in various currencies equivalent to so many dollars. But, as I said before, we have an obligation to give the borrower either the currency he needs to buy the goods or the currency in which the loan is denominated, which is normally dollars.

Q: Can you think of any other loan negotiations besides the Yugoslav one that must have been interesting among the early loans from the standpoint of the use of currencies involved?

Cavanaugh: Uruguay was a problem such as Yugoslavia. In the beginning, of course--Yugoslavia was one of the later ones--it was a fact that we had nothing but dollars and, therefore, we knew we were going to have to put a dollar liability on every one of our borrowers. But our borrowers needed dollars to buy the goods really, so that this worked out. But we had a period of several years where the--starting in perhaps '49, when we recognized this fact that many countries had a greater credit worthiness in currencies other than dollars and therefore the ability to get other currencies was important then.

Q: But the point is that at the very outset dollars were the only currency that was not restricted and the United States was the only country in a position to supply the capital goods anyhow, so up until roughly '49 almost all the Bank loans, perhaps all the Bank loans, were dollar loans.

Cavanaugh: And, as you say, most of the goods were bought in the United States at that time. It was running 75 to 90 percent of the goods bought by our borrowers that was coming from the United States. But then as the other countries picked up, they became bigger and bigger suppliers of Bank-financed goods.

Q: So that sometime in '49 or '50, in that period, you began to be concerned about the problem of which currency to loan, and then the ease-of-repayment question became a matter of some importance, as well as the cost to the Bank of the various currencies it was going to use.

Cavanaugh: Yes.

Q: I wonder if we could talk a little bit about the way in which the Bank has decided on what charges it's going to charge, that is, the interest rate and the commission and that sort of question.

Cavanaugh: Yes, this discussion naturally started, I suppose, even before the Bank came into existence. But certainly the early meetings of the board were largely concerned with the liquidity policy and charge policy of the Bank.

There were many of the executive directors, if you read through the old discussions and papers that were going around in '46 and '47, who felt that we should treat a borrower on the same basis as though he had gone into the market to sell his bonds, which meant that the day we signed a loan, then the borrower should pay an interest rate from that point on. There were those who felt, since we were a cooperative organization, we should charge as little as possible and not charge them anything certainly until he actually got the money. As you know, of course, we don't just turn the money over to a borrower; he only gets it as he needs it to buy the goods, and this might take six or seven years even. The disbursement period sometimes would run as long as 10 years.

Well, as most things work out, this was compromised on the basis that a commitment charge would be levied from the date the loan was signed or shortly thereafter until the money was disbursed to the borrower, and then an interest rate would start.

Initially, this commitment fee was one-and-a-half percent, and this was later changed in 1948 so that--well, I might explain that the one-and-a-half percent applied to the first four loans that we made, which were loans for reconstruction and which were going to be disbursed very rapidly. Then when we saw that we were getting into the loans for development which were going to take a longer disbursement period, we decided that we would try to cover the costs of that longer disbursement period and thus try to treat all borrowers equally.

Also, this one-and-a-half percent that we initially charged should be measured in the light of the fact that it was costing us only two to three percent to borrow funds in those days, and that the one-and-a-half was therefore a big fee in relation to the cost of borrowing, plus what we were getting as investment income. And this approximately left us whole.

On the longer disbursement period, we naturally would have to face the fact that our investment income, plus the one-and-a-half percent might not be enough to cover the cost of borrowing. And so, starting in 1948 we adopted a policy of charging the one-and-a-half percent for six months, the first six months of a loan, and then if the disbursement period ran longer than that, we would charge full interest rate, less what we would earn on the investment in 90-day Treasury bills in this country. This was a very complicated system which made a lot of administrative work to try to keep up with. It wasn't as bad as it would be today only because Treasury bill rates did not fluctuate nearly as much then as they do now. And this policy went on until late 1950, and at that time we had a complete review of the charge system on our loans, and decided that the commitment fee was no longer necessary as a source of earnings to the Bank and that it's primary value would be as a means of encouraging the borrower to draw down its funds and not just keep us as a line of credit. And so, with this in mind we reduced the commitment fee to three-quarters of one percent per annum, and it is charged from the time the loan is signed or 60 days thereafter until the date of disbursement. It does not in any way cover the cost of borrowed funds that we have to borrow in this period.

Now, the interest rate itself, there were many arguments as to what it should be, whether it should be different for the types of currency we lent. For instance, if we loaned 18 percent funds that cost us nothing, should we charge the borrower nothing. If we loaned borrowed funds, should we charge more. Should we make some differentiation between credit worthiness of our borrowers. Should we make some differentiation between whether we loaned dollars or deutschmark or some other currency. And, finally, it was decided that since we were a cooperative organization and because of probably the many political difficulties you would get into in making distinctions between borrowers, and because of the fact that we didn't feel that the source of funds should be a basis of deciding what the charges should be, we set it at a flat rate for all borrowers and the interest rate has always been determined on the basis of what it would cost us to borrow the money, the estimated cost of borrowing at the time you make the loan, plus one percent for the special reserve and plus a quarter of one percent to help cover administrative costs. So that as of today we charge five and three-quarters; that's on the estimate that it would cost us four and a half to borrow today and we add one and a quarter to that and it gets us to the five and three-quarters.

Q: Well, in calculating the rate that you have to pay to borrow funds, do you decide which currency you're going to loan and then try and figure what it would cost you to borrow that currency, or do you take a general average of what it would cost you to borrow currencies generally?

Cavanaugh: We take a general average as a matter of theory; as a matter of fact, we take the U.S. market. This is true because the majority of the funds we have borrowed and could borrow are dollars and even if you took all the other currencies into consideration that we have borrowed or might borrow, this wouldn't be enough to affect the cost. The cost of borrowing in some of the other markets is lower than the United States, and the cost of borrowing in others is higher, and these even out in themselves. But even if they were all higher, the difference is always less than one percent, and the dollar part of our total borrowings is so much larger that the other currencies have not yet become a factor. They might someday, and it might even be that someday if we made a particular bond issue, with the intention of giving that money to a particular borrower, we would take the interest rate of that borrowing into consideration and charge the borrower a different rate than normal. But I doubt that this would ever happen, however, it is a possibility.

Q: Would it be fair to say that the Bank's policy with respect to charges on loans of borrowed funds is that it will just about break even in the long run?

Cavanaugh: Well, it's difficult to assign costs and income to the various sorts of funds that you have, but I think it's a fair statement that we've never made a penny out of loans made on borrowed loans, that the cost of holding funds, the cost of borrowing and after deducting the investment income, still leaves a margin that you just don't recover from the interest rate that we charge.

Q: Can you say that the decisions you've been talking about were pretty well made even by the time the first French loan was made?

Cavanaugh: Yes, the decisions were made; I doubt that anybody envisaged that the interest rate pattern would last as long as it has. There was probably a feeling on the part of many that it would have to be raised when we started to borrow more and more money, when our 18 percent funds were used up and everything would come from borrowing. There was a feeling among others, no doubt, that it would be possible to lower the rate someday, but many of the arguments were that we must not compete with the private market; we must not give money away and thus compete or make it easier to compete with the private market. Even though we could afford to give money away, I think it would be a mistake and I think the majority of the directors and of the management would believe that also.

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Q: I think we had just about finished our discussion of the Bank's development of policy with respect to charges as such. I wonder if you might say something about the maturities that the Bank chooses for the various loans it makes.

Cavanaugh: Yes. The Bank, of course making loans in the basic developmental field, is automatically almost forced into making loans of a maturity somewhat related to a loan by a private company or a private bank. A power loan is normally a loan of 25 years or sometimes longer. When a power company borrows it borrows long-term funds. When a railway borrows money it normally borrows in the 15 to 25-year range. When somebody borrows money for agricultural equipment, they normally borrow in a much shorter range. And so, the maturities of bank loans were designed pretty much from this viewpoint. The basic difference between private lending and the Bank lending is probably on the period of grade that's allowed between the time a loan is signed and the time a borrower has to start to repay, although again you would find a number of power companies that could borrow without a sinking fund involved and would borrow only long term.

The majority range and the fact that we have some annual repayment probably developed primarily from the commercial-lending policies and practices. But in addition, we felt that it had a merit of its own in the ability of a country to repay; whereas any country that borrowed 100 million dollars, if it had to pay average it off in one lump sum, might have great difficulties in getting a hundred million dollars together. Paying it over a period of years, semi-annually, at six-month periods, naturally no one payment was a major burden on the balance of payments of the borrower. The period of grace that we allow on our loans comes from the fact that we feel that until a country or a borrower starts to earn money from what we're financing, he shouldn't have to start repaying us, and so the period of grace will normally correspond with the period of construction and the period that it takes for the goods that are being installed or acquired to start earning money. Then from then on there's a six-month payment spread over approximately the useful life of the equipment that's being installed. On these payments, the Bank gives the borrowers two choices. The borrower can pay equal amounts of principal on each payment date and on top of that pay interest, which means that in the beginning, since we charge interest on the reducing balance of the loan, the first payments the borrower makes are going to be much larger than the latter payments, because the interest will be greater in the beginning.

The other choice we give the borrower is to have a flat total payment schedule, which means that the amount he pays every six months is almost identical, and naturally the first payments he makes the larger part of what he pays is interest and the smaller part is principal. And as you get towards the end of the repayment schedule, the larger part is principal and the smaller part is interest.

I think I might also mention the manner in which we handle currencies, the various currencies we loan. There's an average of a dozen currencies out on every loan. Some have more and some have less. Some borrowers have more and some have less.

Q: Do you mean that in any given loan you're likely to be lending as many as 12 different currencies?

Cavanaugh: That's right. Some of them are as high as 20 different currencies in one loan.

Q: This is aside from the question of what currencies are actually spent?

Cavanaugh: That's right. The currencies spent might be 30 or 40 in a particular loan, but I'm speaking now only of the currencies of repayment. The Bank from the very beginning has retained the right to decide what currency is going to come back at any particular time. And, in fact, we don't make up our mind as to the currency that's going to be repaid on a particular amortization date until about two months before that repayment date comes around.

This gives the Bank the freedom to recover the currencies that it may need to relend, which was a factor in the beginning but which is not so much of a factor anymore. It gives the Bank, however, to get Bank a currency it may need at this particular time to pay off one of its debts. And since we can't predict today what we'll be borrowing tomorrow and what repayment obligations we'll have on our bond issues, we try to keep this freedom and which we feel does not hurt a borrower.

The one other reason for this that I think is worthy of mention is that we want to, in order to fulfill the requirements or the purpose of the Bank, to try to foster private investment, sell parts of our loans. And by not assigning currencies in the beginning to particular maturities, it leaves us free at any time to sell any one of the currencies that are out on loan in any one maturity. Today if somebody comes and says they want a 1965 maturity of a particular loan, that purchaser may be willing to take only dollars, or he may be willing to take only deutschmark. Well, if we have deutschmark and dollars in the loan, we can give him in that maturity this particular currency. So, it does give the Bank this freedom.

Now, this doesn't hurt the borrower in that to the extent that the borrower has to pay foreign exchange anyway, and normally a borrower has convertible foreign exchange today, then he's just as able to pay us one as another. So that this is a factor that makes it possible for the Bank to better carry out its obligations and responsibilities and doesn't create an undue burden at all on the borrower.

Q: Just as a comment that you might comment on, it seems to me that it's a little asymmetrical in a way. When you're making a loan you don't let the borrower use the borrowed currency to go into the foreign exchange market and borrow the currencies he wants, but you do insist that the borrower go into the foreign exchange markets and get a hold of the currencies you want him to repay. Has there ever been any discussion of this?

Cavanaugh: Yes, however, one of the main reasons we wanted to give the currency we were starting with to the country supplying the goods was to help that country. Again, when this repayment comes--say, we'll go back to our example when we used deutschmarks to buy French francs--now, a borrower has to repay us deutschmarks. We feel it's legitimate for Germany, since we started with those funds, to acquire the foreign exchange from our borrower who needs to buy deutschmarks to pay us, assuming the borrower doesn't have deutschmark already from trade. If he does, that's fine. And so, there is a consistency in this of not doing something to hurt somebody but doing something to help the person who is really the one most entitled to that help.

Now, incidentally, in this connection I might mention that since a borrower does have so many different currencies to repay and has to make a payment each six months, this becomes a little difficult for some of our borrowers; particularly in underdeveloped countries, they're not used to going into the various markets of the world to get 20 different currencies, and this causes some problems of their getting the money in on time. And we naturally insist that borrowers pay us on time. And the only reasons there have ever been delays, I think, are strictly those caused by the difficulty of acquiring foreign exchange.

So, some time ago we told our borrowers, after sterling became convertible, that we would agree to take sterling or dollars from any borrower who wanted to give it to us, and we would buy the various currencies the borrower owed us. And this relieves each borrower from the responsibility of going into 20 or more different exchange markets to buy the currencies he needs.

It probably means also, since we are more familiar with it and know how to do it, that the borrower saves money. We get a better exchange rate on purchases than he would. And we do this as an agent for the borrower, and if he gives us less money than we need to buy the goods, he hasn't been paid his loan, and if he gives us more than we need, we turn it back to him. Also, we find that this means we have less objection from our borrowers when we give them the various currencies. Initially, we did find that a number of borrowers just didn't want to get more than one currency. They tried to limit us. Well, this makes it impossible for us to make the best use of our funds, and we couldn't agree with it. Now that we've taken over the burden from them, of acquiring the currencies they need to pay us, most of them will drop their objections, although there are some still who would rather not borrow deutschmarks because they think the deutschmark will depreciate. They'd rather borrow some currency they think is going to devalue, because on a devaluation the borrower benefits. If he owes us so many units of a certain currency and that devalues against all other currencies, then in acquiring that currency he uses less foreign exchange. So, borrowers naturally would prefer to pay us back in a currency that they think will devalue, but we try to treat all borrowers equally and in our using the currencies, as we said, that best fit in with the interest of the Bank also will eliminate the need to try to avoid hurting one borrower by giving him a hard currency and helping another one by giving him a soft currency.

Q: I was going to ask a little later about this question of changes in values of currencies, but perhaps now is as good a time as any. I wonder if you could illustrate what you were just saying with reference to the recent deutschmark appreciation. Did this mean that since the deutschmark rose in value in relation to the dollar by five percent that all borrowers who were obliged to pay deutschmarks, in fact, suffered a five percent loss?

Cavanaugh: Yes, it certainly does. The borrower owed us a specific number of deutschmark and if he doesn't earn deutschmark in his trade and has to use sterling or dollars to buy the deutschmark it will take more sterling or dollars to buy that quantity of deutschmark.

Q: Now, if you had been lending paid-in 18 percent deutschmarks, would the Bank then have been obliged to return some of the deutschmark subscription to the German government?

Cavanaugh: Yes, the 18 percent has a maintenance-of-value clause on it which works both ways. If a currency devalues, the member must pay the Bank enough to make good the devaluation in terms of gold, and, on the other hand, if a currency appreciates in value, the Bank must return the extra amount in relation to gold and you keep a constant gold value on it.

Q: If, on the other hand, the payment in deutschmarks was thought to be payment of deutschmarks which the Bank had borrowed, then the Bank presumably would have been able to keep the exchange gain.

Cavanaugh: Well, the Bank takes no exchange risk, and an exchange risk--most people, I suppose, think of it in terms of a loss--strictly speaking, works both ways. And the Bank takes no exchange risk except on its profits. Now, on 18 percent funds, as we've just described, the member maintains the value or gets the benefit of an appreciation. On borrowed funds, the Bank will get back from the borrower the same number of units of deutschmarks loaned; these deutschmarks are worth more in terms of dollars. But, on the other hand, the Bank has to pay bondholders an equal number of deutschmarks and so it comes out even. Whether the value goes up or down doesn't make any difference. You do have a change in value on your books, but it works on both sides, both on the liability side and the asset side.

On our profits that we have in the various currencies, however, we do have an exchange risk. And if a currency devalues, in which we hold some of our funds that we acquired through interest and earnings on our loans and investments, then if it's a devaluation we lose; if it's an appreciation, such as the deutschmark, we benefit. Last year we had a little over a three-million-dollars appreciation on our books because of the re-evaluation of the deutschmark and the guilder and because we recognized the appreciation that occurred last year and several years in the Canadian dollar. On the other hand, when the French franc devalued, we took a loss. On net basis, we've come out with more profits than losses in the exchange field.

Q: We've talked quite a bit about the 18 percent paid-in capital, but I wonder if there aren't a few extra points we should clarify. In what form, specifically, does a member-government pay its paid-in capital?

Cavanaugh: A member pays its two-percent, of course, in gold or dollars. We tell them we prefer dollars on the grounds that we don't want to hold the gold--if we get the gold we'd sell it. Incidentally, I might mention that this was a decision that was made in the very beginning, that the Bank would not hold gold--not that we don't like gold but it was felt that all the funds that we had should be usable and gold could be used to lend, but it's difficult. And the fact that to hold gold costs you money was another factor; you earn nothing on it, but you have to pay costs of vaults and of storage and so forth. So, we early decided that any gold we received we would automatically sell and invest the funds either short term or disburse them on loans, if that were necessary.

Q: You would sell it to the Federal Reserve or the International Monetary Fund?

Cavanaugh: No, we sell where we'll get the best price. Sometimes we've sold in Europe, sometimes we've sold through the International Monetary Fund. The Fund doesn't buy itself; it only acts as an agent for the buyer and the seller. And sometimes we've sold to the U.S. Government. It depends on the condition of the gold market at the time we receive the gold.

To get back to the capital payments of the Bank, the 18 percent portion is paid in the currency of the member and theoretically they must pay it in currency. And then to the extent we don't need that currency in the operations of the Bank, they have a right to substitute non-negotiable, non-interest bearing demand notes. Some countries do and some countries don't. The bigger countries normally substituted notes and we cashed those notes as the countries released their 18 percent for lending and as we needed them for disbursement we would cash the notes and then disburse the currency.

In some countries they can create a bank account just as easily and just as non-budgetary-wise as they can put in a note. In some countries the amount of currency printed is regulated by the amount of their foreign exchange reserves or gold holdings, and so forth. In other countries there are no such limits. The United States, for example, has a limit on the amount of public debt, and to the extent it would pay in cash to us rather than in non-negotiable, non-interest bearing notes, it would have to sell bonds and pay interest on those bonds. So, there's a definite cost advantage to the United States in substituting notes. In some other countries they can print the paper in the form of notes or currency, one as easy as the other. Usually those countries paid us in currency in the form of a bank account, but which was to all intents currency; they didn't bother to substitute notes.

Q: Wow, I believe you told me once before that on some occasions some countries, at least the Philippines, have asked to be able to pay their currency subscription in currency other than their own.

Cavanaugh: When we got to the point of getting the releases of non-dollar currencies from the underdeveloped countries, the 18 percent portion of the subscription of the underdeveloped countries, we were getting into the field of currencies that just aren't used in international trade. The only way we could use these was to convert them, and, as we discussed previously, the borrower always had to pay us back in the currency that we started with. Prior to the time that we adopted the policy of accepting sterling or dollars in buying currencies for a borrower, the borrower had to get all these various currencies himself. And if he owed us in a currency of some of the members whose currencies are not used in international trade, it's often very difficult to acquire them. You have to go primarily to the central bank and a purchase of any size might very well substantially affect the exchange rate.

So, we found a reluctance on the part of borrowers to accept these what some people describe as exotic currencies. To get around this we had a talk with the Philippines and they suggested that instead of their releasing their 18 percent and our taking it and then converting it as we needed it, to buy the currency that the borrower wanted, that we sell it to them for dollars and then we loan the dollars and get back dollars from the borrower. This arrangement we found was possible under the articles of agreement. By doing this, the member who is releasing gets out of a maintenance of value, so that they have paid already dollars to the Bank in effect--they've bought back their own currency for dollars--and they therefore have no maintenance of value.

It has another big advantage to the releasing member in that let's assume that Colombia releases its 18 percent as pesos. Whether we disburse it to the borrower as pesos or not is not material in this. In any event, the borrower would have to repay us pesos. And let's assume that the total is, say, 10 million dollars at the time we disburse. So that the borrower, therefore, has to pay us--and let's say that the exchange rate at that time is one-to-one--so that he has to repay us 10 million pesos.

Now, if in the meantime, the peso devalues--say, that it becomes two-to-one--then the borrower is paying back only 10 million pesos which at that point are worth only five million dollars. So, the borrower would take five million dollars and go to Colombia and buy with that five million dollars 10 million pesos. Now, if Colombia says we can lend this again, which we would expect them to do, again they have, as soon as the money comes in, to maintain the value of it; they have to give us twice as many pesos. So we now have 20 million pesos, which again are worth 10 million dollars. So, again, we take the pesos and convert them into 10 million dollars. Well, Colombia has lost five million dollars in this process. And so, it is to the advantage of any country to avoid this risk of the devaluation of their currency to go through this process of the Philippine-type deal, of selling us dollars originally. They would sell us the 10 million dollars; we'd return the pesos, and they'd never have a maintenance value, and their total exchange cost is 10 million, and that's all. And they'll always get back 10 million anytime they want to; this is a reversible procedure.

Q: Is there any country other than the Philippines that has taken advantage of this arrangement?

Cavanaugh: There are about 17 countries that have done it. I mention Colombia has just now agreed to do this for its entire 18 percent.

Now, some people objected to this on the grounds that it tends to depart from the international character of the Bank to turn all of these currencies into dollars. But I think it is a wise thing to do; it gives the borrower a repayment liability that is normal. It has a benefit to the releasing member. It has no harm to anybody except the harm of pride, I suppose, of saying this is a dollar institution.

There are those who feel that we should do this not only for dollars but for other currencies. Well, in the past the dollar was the only currency that was stable for any length of time as a general matter. Now that there are more currencies convertible and there is a stability in a number of them, it's possible that we would do this same thing not only for dollars but for some other currency. It becomes much more complicated administratively to do it for another currency because the capital in all of our books are kept in dollars; and it makes it easier to handle it. But it's very complicated administratively to do this even. If you'd do it in another currency, it becomes very difficult to define the value of what they're going to buy back or get back if anyone, any country, wants to reverse the procedure.

Q: In this process of trying to induce the member-governments to release their 18 percent capital for use by the Bank, what steps has the Bank taken? Has it ever, for example, in the case of loan negotiations suggested that it would be easier for the borrower to get the loan if that particular borrower would release its 18 percent?

Cavanaugh: I don't think we've ever used blackmail to get 18 percent but I think we've used almost every other what we think is fair but forceful arguments. We feel, the management and the executive directors feel, that anybody who signs the articles of the Bank has an obligation to make this money available. And, as we were saying previously, it is customary for almost all countries to be both borrowers and lenders. This is part of the normal operations in the world. And, therefore, we think it is not at all inconsistent that a member who is getting loans from us is better able perhaps to make their 18 percent available. And certainly the fact that we were willing to make loans to the country is an indication we're on better terms with them and they with us, and therefore there's more opportunity to explore the 18 percent release possibilities and it's human nature that if somebody is doing something for you, you're more willing to do something for them. Although we haven't said you won't get a loan if you don't release your 18 percent, these two have on occasion happened at the same time. Or at least that countries we were making loans to released their 18 percent.

Q: Do you feel that Mr. Black's own personal way of negotiating is part of the explanation as to the Bank's success in getting these 18 percents released?

Cavanaugh: I think there's no doubt about it, that he's been able in many cases to obtain releases that no one else could possibly have obtained. The members have a respect for him and a willingness and desire to cooperate with him and so it's happened.

Q: Does the management sometimes ask the help of the executive directors on this?

Cavanaugh: Yes, on certain occasions the executive director will assist in obtaining a release, explaining the Bank's side of the story and telling his country that this is something that should be done. I think we've used every means that has been in our possession. I think it hasn't hurt anybody who has released and has been of great benefit to the Bank, public-relationswise, and also to our borrowers in making various currencies available. There were many people who felt that this was just the U.S. Bank. There were other people in the United States who felt, gee, we're doing everything and nobody else is doing anything. When you can point out to those in the United States that, look, the other countries have put up more than the United States has in the way of capital amount, it's a very important argument and shows that the United States is not doing everything. On the other hand, it, worldwise, has enhanced the international character of the Bank.

Q: I should think that in any event it wouldn't hurt a country to release its 18 percent so long as it didn't enter into this Philippine-type payment and if it were a country whose currency was almost never going to be sought by a borrower. Take a country like Ghana for example; if it released its 18 percent but didn't pay dollars and paid its own currency into the Bank, the likelihood that the Bank would use this is pretty small. Isn't it?

Cavanaugh: Well, it just happens that the Ghanaian pound is a convertible currency and their reserves are big, but we have many countries whose currencies are not convertible, and therefore their saying we can use it, unless they are willing to convert it for us, does us no good.

Q: About what percentage of the total 18 percent subscriptions has been made available now?

Cavanaugh: About 80 percent is now available.

Q: I wonder if we could talk a little bit more than we already have about the Bank's sale of bonds. I'd like on another occasion to talk about some of the specific problems of marketing of bonds, so that's not the issue now, so much as how the Bank decides what particular currencies it wants to borrower. Is there a relation between this and what currencies its borrowers want to borrower? And how does the Bank decide the total amount of bonds it is going to try and sell? Something about the liquidity policy of the Bank, and all this is involved.

Cavanaugh: Initially, the Bank followed the policy of never making a loan unless it had the funds available to cover the loan. Now, this meant that we had to borrow funds before we made loans. In order to arrive at the timing of borrowing, from the theoretical viewpoint, we would take our known releases of 18 percent funds and what we expected in the next year and then the next two years and so forth. We took our disbursement schedule of loans, and we took the total cash on hand, or total holdings, and by combining these we arrived at an estimate as to when we would run out of funds. Then you also must estimate on top of that what new loans you're going to make as you go along, so you know the time you have to borrow and the amount you have to borrow.

Well, a lot of these are uncertain factors and create difficulties in arriving at a good picture, and all you can do really is take a range: that if this happens, this will be the result; if this happens this will be the result. So you take your range and you come up with a figure that you have to borrow a hundred million at the end of four months--it may be six months--you have to borrow another 100 million at the end of six months, and it may really be 10 months before you really have to do it. You can't pinpoint these things exactly.

Now, the Bank in 1952, when it found that it could borrow funds almost at any time it wanted decided to change this liquidity policy of a hundred-percent coverage and adopted the policy at that time, which has been followed since, that as a minimum the Bank would hold what funds it would need for disbursement in the next year, and since essentially loans are on a four or five-year disbursement period it meant that we could hold something less. Now, this all has to be tempered with the fact that: do you think the bond market is in a good position now? Are funds freely available or aren't they? Do you think that in the next six months they'll be more freely available? In the next year what do you think? Are interest rates going up or are they going down? These are guesses; it's difficult to know.

The more difficult thing to guess that you have to guess is the timing of when you can borrow. You can let the cost figure take care of itself more. You must be willing to pay what the market is going to charge you. But the question of can you borrow is more important, particularly since you try to borrow internationally.

Now, you ask do we try to borrow one currency rather than another. Initially, as we were discussing, we wanted non- dollar currencies if we could get them. But the non-U.S. markets are not available at all times. The governments have a control over them in order to try to spread their scarce funds around. Whereas in Switzerland they will let us borrow once or twice a year, sometimes twice, most other countries wouldn't let us borrow more than once a year. In fact, a number of countries have closed their markets for four or five-year periods at a time.

The U.S. market has always been open to us, but you could never be sure that it wouldn't go through a period when money would be very tight and the U.S. government would be reluctant to have us borrow--even if they would permit it, they would be reluctant--and perhaps this is one of the periods, now that the U.S. is in a gold crisis. Fortunately, we haven't had to borrow in the United States, and fortunately we have been able to get all the funds we needed elsewhere and at cheaper costs. Even when we've sold dollar bonds, we have often sold them outside the United States and have done it on a more advantageous basis than we could have had we borrowed the funds here.

The liquidity policy we make thousands of calculations as to what are the effects of lending five hundred million a year, six hundred million a year, or seven hundred million a year. And are you going to sell a hundred million out of your portfolio every year? Or will you sell five hundred? Will you disburse 400 or will you disburse 700? These are all things that you can only use the past as a guide and try to predict the future. And, as I say, the net result is really taking a range of all these factors and seeing what the result would be if this range in each facet works out. And it so happens that during the period of high interest rates in this country we didn't need to borrow; we had borrowed more funds than we actually needed back in the middle '50s, when rates were lower, in '56, '57 and early '58, and then when rates went up in this country, we didn't have to borrow.

Now, I say Mr. Black has a sixth sense; he knows when things are going to happen. He knows this timing question of the markets of the world better than anyone, I think, in the world. I think he has a broader grasp of the world bond markets and the world capital markets than anybody I've ever seen, and he's in a position where he can talk to all the men in the world who knows markets and get the feel from each one of them as to what is the situation. He's therefore in a better position to judge than anybody I know as to what is the best timing to meet.

Now, as to the timing on foreign issues, it's really largely been governed by when were those markets available to us, the amounts that we could get at any one time, were within our means to borrow an extra 14 or 15 million when you may not actually need it at that time isn't so bad. Now, in this country when we borrow we wouldn't want to sell less than a hundred million at a time to the public and, therefore, the timing becomes more difficult.

Portfolio sales have been high in the last few years and our loan disbursements low; there are four at the moment. We are very liquid in funds; however, we must keep in mind that although we have something over a billion and a half of liquid funds, we also have a billion and a quarter of undisbursed loans. So, we really don't have a tremendous over-liquidity. The fact that we have so much money is because loan disbursements are slower than you could normally have expected them to be. So, both sides of this picture should be much lower.

Q: What does the Bank do with this billion-something of liquid funds that it has? How much does it keep in cash and how much in short-term treasury bills, etc.?

Cavanaugh: We have it in a number of different currencies. In each country we do have to keep some cash balance, and it varies from country to country. But, basically, we invest our funds either in government securities or time accounts in each of the countries.

In Japan, for example, we have treasury bills. We earn on those short-term treasury bills over six percent. In Holland treasury bills are very scarce; this is true of Belgium, Holland and Switzerland. There isn't really a big market for treasury bills. There are a lot sold but they're bought almost entirely by banks who hold them entirely to maturity. So, if we need liquidity we need to be able to get out of something when we need it. We may have a disbursement request for a million dollars today, or it may be 30 million dollars; we don't know. We try to disburse to our borrowers within 24, at the most 48 hours, after the borrower wants the money. So, we need liquidity, and treasury bills, therefore, are only good for us to invest in if they're liquid. On the other hand, in these countries in Europe, there is a custom of paying interest on short-term accounts; on a regular checking account, in effect, you can get from a quarter to a half of one percent, on a three-day account, a seven-day account, on a three-month account. These rates vary from time to time between countries, but they have a custom of paying interest on short-term accounts which does not exist in the United States. On a checking account here it's illegal in many states to pay interest.

So that in those countries we put our money in time accounts normally, although we have from time to time, when we've been able, when we had an excess of funds of a certain type and when the interest rate was high enough, we would buy a six-month or one-year treasury bill.

Now, in Germany, Canada and England and in the United States there is a treasury bill market, less so in Germany than in the others. And in these three countries you can buy and sell government securities, including the treasury bills, fairly readily. In Germany, we've made a special deal with the Bundesbank to buy and sell from us, so that we've overcome the fact that there isn't a public market, a large public market, to give us liquidity. We've overcome it by getting an agreement from the Bundesbank, the central bank, that they will buy and sell from us.

For the first few months of the Bank's operations, we were allowed to invest only in treasury bills. Well, in about the middle of 1947, when we began to accumulate some extra funds out of borrowings and our profits began to build up, the board authorized the investment of our U.S. dollars up to five years in U.S. Government securities. And then in 1951, when we began to have bond issues and earnings in other currencies, this board authorization was broadened to allow us to invest up to five years in any country.

The commercial banks in the United States have always been after us to open time accounts with them, and for many years we didn't do it because it was too difficult for us to narrow down the 14 or 15 thousand banks in this country that we would put money with. And, obviously, we couldn't put it with 15,000 banks. After we had some experience with selling bonds and had found out who was buying our bonds, and later who was willing to buy parts of our loans from us, it gave us a list of banks then which were doing business with us and were helping us and which we felt gave us a criterion to use in determining that these are the only one we'd put money with. So, we went to them and asked them if they wanted time accounts and in those periods when the interest we could earn on time accounts was larger than we could earn on short-term treasury bills, we did open time accounts. At the moment we have about 250 million in time accounts in this country.

Q: Do you ever shift currencies for short-term purposes?

Cavanaugh: No, we never take an exchange risk by shifting. We never convert one currency into another and invest the currency which we bought.

Q: Never deal in forward exchange.

Cavanaugh: No, we don't deal with forward exchange. We feel that we are owned by governments and to the extent we would benefit one country by switching and buying forward and being a hot money expert, we would be hurting another of our member countries. And, therefore, we feel it is not appropriate for the Bank to try to squeeze the last penny out at the expense of one of our members. We want to earn the most we can without hurting anybody. I think this philosophy flows throughout all the Bank's operations, that to the extent that we can benefit the Bank as such and not hurt anybody else, we want to do it. To the extent it does create a problem or a burden on one of our members, we would much rather avoid doing that.

Q: If you suspected that a currency was going to be devalued--I'm not even sure this is an appropriate question--I guess what I'm trying to get at is: Is there anything that you can do to get off the hook of the exchange risk of a potential devaluation of the currency you hold by lending it sooner than you might have otherwise done?

Cavanaugh: No, the only thing we could do--to start with the only exchange risk we have is on our profits, the money we've earned from interest and income on our investments and loans. Initially, we converted all our non-dollar currencies earnings into dollars. After about two years of this the board then decided that we didn't need to protect ourselves and we should take the risk and not convert into dollars because by converting we were creating a burden on the foreign exchange reserves of each of our members. So, on our profits we do keep them in the currency. Lending them wouldn't get us out of the exchange risk because it only postpones the day when you're going to take the actual currency risk or loss or profit.

But we have had a number of occasions when we were holding cash balances of certain currencies and were fairly certain that the devaluation would happen shortly and it was difficult to sit there and not convert into something you thought wasn't going to devalue. But we realized that this was a burden that we had to suffer through, otherwise we might lead the ranks of claimants who, if somebody found out we were doing it, they would say well, this devaluation is going to happen, the World Bank thinks so, and we would, again, have hurt a member. No, we've taken losses that we didn't have to take strictly speaking, but we did it to avoid hurting a member.

Q: I should think there would be many accounting problems involved in dealing with so many currencies and so many maturities and so many borrowers and distinguishing 18 percent borrowed funds from profits and so on. Is there something you could say about this issue?

Cavanaugh: Yes, we have not only some 75 different currencies that we have to keep track of, but in each of these different currencies there are very many types of currencies. For example, with dollars, we've got two-percent dollars and 18-percent dollars, we've got profit dollars, we've got special reserve dollars, we've got borrowed dollars, we've got a gold dollar and a legal tender dollar. We have to keep track of the different types of dollars under the articles in many cases. For example, if 18 percent dollars are out on loan during a year that the Bank declared a dividend, there's a two-percent preferential dividend paid to each member on the basis of its 18 percent cut on loans. So that we have to keep track of 18 percent dollars separately from all other dollars so that we would know how much dividends to pay the United States if and when the Bank ever pays a dividend.

Furthermore, the 18 percent dollars are limited in their use, or could be limited. The U.S., although it has agreed we can lend them all, could retract this, and therefore, as we got the currencies back we would have to earmark them again. The borrowed dollars and the profit dollars are in a field pretty much of the same. There isn't much of a distinction except, again, it's possible under the articles that a dividend would be based also on the two percent that a member had paid or was out on loans. This is a possibility. Although since they're all in dollars, obviously no one would agree that that should go to the United States, so maybe this won't become a factor. But on each loan, obviously, we have to keep track of the different currencies that are out since the borrower has to pay us back and he's got to know what currencies he's got to pay us and we've got to know what are due from him.

Up until recently we had to make this distinction in every loan, not only that they were dollars out on loan, for example, but what kind of dollars were out on that loan. This ran us into thousands and thousands of accounts. You only have to take your various currencies and then multiply them by the loans and then multiply those again by the various types of currencies and you find that very shortly this multiplication compounds itself so that you've got just thousands and thousands of accounts.

Well, last year we proposed to the executive directors, and they agreed, that starting January 1 of this year actually we were able to discontinue the need to keep track of each type of currency in each individual loan, and it was agreed that we would consider loans as a whole. And we know how much 18 percent currency of every country is out on loans. So we don't need to keep track of whether a dollar in this particular loan is a borrowed dollar or an 18 percent dollar or is the deutschmark a borrowed deutschmark or is it an 18 percent deutschmark. And we've adopted just an overall approach to it, that as long as nothing happens, we will consider all repayments as being borrowed or profit repayments, and this is necessary since we have to be able to take care of our borrowings. If there is a devaluation or an appreciation of a currency, or if a member who has agreed we can lend 18 percent declares that they're no longer willing to have us do it, then we cut off at that date. And if at that point there are two units of borrowed funds out for every unit of 18 percent, this is immaterial; it's just the total borrowed and the total 18 percent cut. If it's a hundred million of borrowed funds and 200 million of 18 percent, then the first money we get back, the first hundred million we get back, is going to be borrowed funds; the next two hundred million is going to be 18 percent funds. And this has saved us a tremendous amount of work.

Q: It sounds like you might characterize the 18 percent accounting system as a first out, last in sort of an approach.

Cavanaugh: Yes, that's true, and the need for this is, of course, the fact that our bond holders must come before our members. We must be able to get back money to pay off our bonds.

Q: I think you might mention for purposes of the tape that there's a memorandum on this subject dated December 19, 1960. Does that identify it adequately?

Cavanaugh: Yes, it's a paper that went to the board. It's titled "Allocation of Currencies to Loan Maturities," and it's the paper the board considered and agreed with.

Q: I've reached the end of the things that I felt I was terribly anxious to discuss. I wonder if there aren't some things that you'd like to add on your own. I probably haven't had enough sense to bring out some of them.

Cavanaugh: No, I think you've very exhaustively explored the financial fields of the Bank and what we do in the treasurer's office.

Q: There is one other last question I might ask then. As far as the loan policy of the Bank is concerned, are there certain types of projects which might be frowned upon in the staff loan committee or elsewhere in the Bank on the grounds that it was a sort of project which the New York investment market would not think too well of?

Cavanaugh: Obviously the opinion of a potential bondholder or an actual bondholder is going to be important in deciding what the Bank does. I think the Bank has been very courageous in going into fields and making loans which some people may have disliked, such as the loan to Yugoslavia. And so, I don't think the Bank scares very easily but obviously too we're not going to get ourselves into the position where we are constantly or as a matter--

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Q: Welcome back, Mr. Cavanaugh, for our third recording session. I believe that at the end of our second session you were just beginning to talk about the question of whether the possible reaction of the investment market would have some bearing upon the lending policy of the Bank. I wonder if you could say a few words about that, before we go on to other subjects.

Cavanaugh: I think, undoubtedly, the management and the staff keep in mind in any lending operation what the attitude of the investors might be toward it. I think it's probably also true that the general feelings of the project approach and the general feeling, first, that we must finance things of top priority that are going to lead to the maximum economic development of a country, tied in really with what are the most important things for the Bank to do. And this being so, the market opinion on them, we feel, would be quite the same as ours, and so that really there is no difference or certainly very little difference between what the Bank would want to do, whether or not we were selling bonds. It is possible under the articles to be more flexible than the Bank has been perhaps. Certainly the Bank was very cautious when it made a loan to Yugoslavia, as to what would be the market reaction. And there were many people, when we made the loan to Yugoslavia, who felt that there would be a very adverse reaction. And the same thing was true when we made a loan to Egypt, and the same thing was true when we loaned to Israel. However the Bank under its articles it must ignore--political situations, and it probably bent over backwards in trying to explain to the market why we did these things, so that the market would understand. And I think the market did accept the fact that we made these loans and there was no general adverse effect. We had a lot of letters criticizing us for each of these transactions.

Now, when it comes to individual projects, I think that the lending policies of the Bank, which were made because of the feelings of the people of the Bank, are consistent with what an investor would think would be a good and prudent investment.

Q: In the case of the loan to Yugoslavia, was there any connection between the possible adverse reaction in New York and the fact that the Bank decided that it would actually disburse for that loan European currencies? And that the Bank about that time began developing the market for the Bank's bonds in Europe?

Cavanaugh: No, I don't think this was a factor. I think that we loaned other currencies to Yugoslavia entirely on the feeling that Yugoslavia's export earnings were non-dollar currencies and that the few dollars it did earn were needed to finance the dollar debt it had already incurred. So, I don't think that the New York market led us to this limitation on the Yugoslavia loan.

Q: And in the case of specific projects, do you think that the New York market would react adversely to the financing of those things which would not directly lead to physical goods output? I have in mind, of course, such things as projects to provide better education or housing or public health, things of this sort, in developing countries.

Cavanaugh: I think that if we got into the social field in the Bank then the bond market would definitely feel that we were not acting prudently from a financial standpoint and they would judge it on the basis that they feel that the loans we've made so far have helped to increase the internal economy and the foreign exchange earnings, or saved foreign exchange, and thus had helped our borrowers earn more to be able to pay us back. If you start financing schools and hospitals and water works, and so forth, these things don't normally and directly increase the ability of a country to repay a borrowing. I think they would judge it, not on the grounds that they don't like these things, but just that they don't feel that this is a field in which we could prudently hope to lend and get the money back and, thus, be able to repay our bonds.

Q: In any event, you feel that the sort of loans that the Bank makes has some effect on the ability of the Bank to raise funds regardless of the guarantee of the United States Government.

Cavanaugh: I think, obviously, this is true. I think it has not only an effect on the quantity we can raise but more importantly an effect on the price which we would have to pay. A soundly run organization can borrow money more cheaply. With the guarantees that we have people would not worry about getting their money back but they'll make us pay more for it if they feel that the only way they're going to get it back is after we collect it from our borrowing countries.

Q: Do you feel that in general the Bank has been able to borrow on the best possible terms?

Cavanaugh: I think that undoubtedly the Bank's credit is, in any country, next to that of the government, and in some countries we've even borrowed more cheaply than the governments themselves have been able to borrow, or government agencies which are guaranteed. For example, in Germany, when we put our issues there, we paid five percent. The railroads in Germany, which are owned by the German Government, and which are subsidized and which are efficiently run, but which the German Government must subsidize, they had to pay three-eighths of a percent more, and there were no other differences in the two issues, and they came out within two weeks of each other. So, it proves what you lend for and whether something is subsidized or not is an important factor in an investor's opinion as to whether he's going to want to get paid for putting his money to work.

Q: Were the railroad bonds of the German Government revenue bonds or general-obligation-bonds?

Cavanaugh: General obligations of the railway, which in turn is a government-owned enterprise. It had the same tax status as our bonds;

they were both denominated in deutschmarks, and they both had the same maturity; and they both were of the same amount, 200 million deutschmarks. So, there was no discernible difference between the two bonds, and you would naturally think that since it is a German Government bond any German citizen would prefer to buy his own government's bonds than a World Bank's bonds. But this wasn't the case; they were just worried about the soundness of the railroads because they were subsidized.

Q: Well, I suppose I'm getting a little ahead of the story, because I'd like to ask the development of the bond market of the Bank in a more systematic way. But before we get into that question as such, I wonder if there are some things you want to add to our first two recordings.

Cavanaugh: I'm afraid I don't remember enough about the first to add anything to them, so I think we might just as well start talking about the bond market as such.

Q: Well, I wonder if we might talk first of all about the development of the bond market in the United States. Could you just tell about some of the first bond issues and interesting characteristics of them?

Cavanaugh: You will recall that in 1947 when we put our first bond issue one of the biggest problems was to make them legal investments. Dr. Black and a number of others did a tremendous job in discussing the character of the World Bank with the various legislative committees in the various states and with the banking and insurance supervisors in the various states who had the job of assessing paper and deciding whether it could be eligible for bank holdings, for instance company holdings, for trust holdings, for pension-fund holdings. There was certainly a general dislike of foreign obligations, arising during the '30s when so many of the foreign loans in this country were in default. And so, most states had restrictions that permitted the various investments in the United States-issued securities and usually Canadian Government securities and municipal securities to some degree, but no other foreign obligations were permitted.

Q: Are you saying that at the time Mr. McCloy became president, in March, '47, there was just no market for the Bank's bonds at all?

Cavanaugh: I think that's largely true. Actually, this job started a little earlier than in March of 1947, of trying to develop the market, but there were many people in July of '47 even, when we put out our issues, who said that we wouldn't be able to sell them, that the American institutions and public would not buy World Bank bonds because the World Bank was a foreign organization. Well, obviously, the fact that the U.S. Government guarantee was on it was the key factor that led to the success of the issue. Nobody knew how the Bank was going to be operated and whether it was going to be a soundly run organization or not, but they did trust McCloy and Black and the people who were together in the World Bank at that time. And I'm sure they placed more importance on the U.S. Government guarantee.

Q: I have heard that some work was done by people in the United States Treasury before the Bank became an official organization, to try and get some legislation changed to admit the Bank's bonds, in particular New York State, I think.

Cavanaugh: To my knowledge, there was little done by the Treasury except in the national bank field and in the Securities and Exchange Commission. This work that they were doing, I believe, was all instigated again by the staff of the World Bank in trying to make our bonds legal for investment by national banks and for national banks to trade in World Bank bonds. And as far as SEC was concerned, to get us freed from the restrictions of the SEC.

But as far as I know the Treasury did not enter actively into any other field.

Q: Well, to make the bonds marketable for national banks, it required federal legislation?

Cavanaugh: Federal regulations and federal legislation and a ruling by the controller of the currency.

Q: When did such a ruling first get made?

Cavanaugh: Early in '47, I believe. I forget the exact date. I'm sure it was in the first half of 1947.

Q: Well, in any event, by the time Mr. McCloy became president, only national banks perhaps were in a position by legislation to buy Bank's bonds?

Cavanaugh: There would have been some states where there was no problem by that time, and also almost all institutions were permitted to use a part of their assets to buy any bonds they--what is called the basket clause really. There's a part, sometimes it's five percent, sometimes two, sometimes 10 percent, where an institution is permitted to buy obligations of non-approved obligations. But other than this there were very few that had been cleared by March '47. It was primarily between March and July that the clearances were largely obtained and, of course, a lot of them have been in later years even.

Q: What was the situation in New York State?

Cavanaugh: I don't remember the timing on New York, but I do know that the clearance was obtained before in New York, New Jersey, Pennsylvania, Connecticut and New Hampshire; these were obtained before July.

Q: But you think subsequent to March?

Cavanaugh: I just don't remember.

Q: We can look this up. I was trying to establish what sort of a job was really involved here.

Cavanaugh: Well, a lot of this took months, I mean, in any one state sometimes, and sometimes it took years in any one state. So the fact that the approval came through on a certain date, in July for example, does not mean that you didn't start it in January. It's a question of talking to the committee in the legislature, talking to various men in the supervisory offices, and then their having their own meetings, and then perhaps us going back and talking again. This was a lengthy process in some cases.

Q: In any event, there's no doubt in your mind that the market really was opened up to the Bank only after Mr. McCloy and Mr. Black began to work on this.

Cavanaugh: Only after Mr. Black began to work on this. That's when it started. There’s no question that it was after Mr. Black started that they really broke the back of this thinking.

Q: I didn't mean to interrupt your complete narration. I just wanted to see what could be said on this point of timing. Could you now go ahead and say what you were going to say about the first issues?

Cavanaugh: Well, on our bonds we had a debate. The main question was should we make loans before we issued some bonds, and the decision was made that if the Bank was going to be really successful it had to have something more than its capital, and that we might just as well start out and try to borrow money and see whether we could immediately, or else there was no use thinking of us as a big institution. There were a lot of people who argued: let's make a number of loans and then in a year or so borrow some money so that the market and the investors would have a chance to assess us. There were others who said: that's too long to wait; you're going to use up the only money you have available and you'll just be stuck, and then you'll have to pay more for the bonds because people will know you're stuck. And the only way you can lend more is to borrow.

So, Mr. McCloy and Mr. Black decided that it was wise to go ahead and find out. They felt that the main selling point was the U.S. guarantee; we already had it, and that wasn't going to change. And that it would take a number of years before the market would reach a judgment as to the soundness of the way the Bank would be operated. So that before the judgment could be reached by the market, we would have to sell bonds to do business, particularly if we were going to make the kind of loans we had to make in those days, of 250 to 100 million dollars--250 million to France and a hundred million to the Netherlands. You must remember that we had only the 571 million of the U.S. really available to us. So that this forced us into the market immediately.

There were many discussions as to the type of marketing arrangements that would be made. It's possible that we could have had people willing to underwrite the issue but I think we would have paid a tremendous price to the underwriters. Therefore, it was decided to offer it without underwriting and to offer it on an agency basis, that we had various securities dealers selling bonds for us. And there were many discussions as to whether we should try to limit it to a few of the larger dealers or whether we should open it up as widely as possible. And Mr. McCloy and Mr. Black decided we should open it up to as wide a group as it was possible to get together. And so actually the sales were made on our first two issues, which were offered simultaneously, through about 1700 securities dealers around the country. And they merely sold them and got paid a commission for selling these bonds. They took no risk at all because they weren't underwriting.

The two issues--one was a 10-year issue at two-and-a-quarter percent, and the other was a 25-year issue at three percent--were both very successful. The short-term issue was 100 million dollars, and the other one was 150 million, and they were completely sold. That was in July of '47.

Q: One question about that. How was it decided how large an issue to sell? I've heard that there was some discussion that the first issue might even be as high as a billion dollars.

Cavanaugh: Certainly there was discussion. The U.S. Government was offering issues of a million dollars or more, but no one else was, and it was felt that even 250 million was a tremendous sum. There were a lot of people who felt we should try with 25 or 30 million or 50 million. But the largest private borrowers were in the 100 to 200 range. Two hundred and fifty was a tremendous issue. And so we felt that we could fit in with far below what the government could borrow but something certainly as much as the best and the largest private borrowers could borrow. And also a factor was that we were making loans of 250 million dollars to France and it was felt that we would be making other large loans, although perhaps not that big. But the only real test was to borrow at an amount as large as possible, at least in the 150 to 300 million dollar range. I don't think anybody with a knowledge of the market felt that we could go up to the billion.

Q: Did the Bank's staff and management receive any cooperation, so to speak, from the United States Government in helping to advertise the banking of the United States Government?

Cavanaugh: Well, I think, obviously, the people in the United States Government, as they were talking to people around the country, were a big help to us. Just in their normal course of business the question of the World Bank would come up, and they certainly did all they could to help the reputation of the Bank and the fact that the marketing of our bonds was important and that, to the extent that our total outstanding bonds were less than the U.S. guarantee, there was a safety factor involved. But, to my knowledge, actually the U.S. Government people did not do much in promoting this issue.

Q: Was there ever any thought of including on the face of the bonds themselves the statement that they were guaranteed by the United States Government?

Cavanaugh: This is prohibited by our articles of agreement. Our articles of agreement, in fact, say that every bond that we issue, every security, bond or note, must bear on its face the legend which says this is not an obligation of any government. This guarantee feature was, of course, promoted widely by us. A prospectus contained the statement that the 80 percent portion of the capital could only be used if and when needed to pay off debts of the Bank.

Q: Did any question arise as to whether the U.S. Government guarantee would hold even though some of the other member governments of the Bank did not honor their own guarantees?

Cavanaugh: Yes, and there was a specific interpretation of the articles even before the issue was placed stating that each member's liabilities was independent of the other members' liabilities, and that if one defaulted that didn't excuse anybody else from defaulting.

Q: Did the U.S. Government make any statement to the effect that it would stand behind its guarantee regardless of what other governments might do?

Cavanaugh: I doubt that they did. I think they didn't because it wasn't necessary, and people trusted the United States Government to stand behind their obligation that they had signed their name to, and that it wasn't necessary for any specific speeches or statements to be made to say that we'll live up to our word. I think this was not done because it wasn't necessary.

Q: How did the Bank decide the exact interest rate it was going to pay? Obviously it was related to the interest being paid by the United States government on its own bonds. Beyond that, will you say anything?

Cavanaugh: The management certainly looked at the price that the U.S. Government had to pay when it sold bonds at similar maturities. It looked at the price at which private companies would have to pay. Many discussions were held with lending underwriters as to what their beliefs were. And the bonds were priced at a yield of between a half and three-quarters of a percent more than the U.S. Government's, and between a quarter and a half above what the top corporate borrowers had to pay, so that we actually paid more than the top-grade power companies and others in that field.

Q: Do you happen to recall the names of some of the leading underwriters who were consulted at that time?

Cavanaugh: Well, I'm sure Morgan Stanley, First Boston, C.J. Devine, Halsey Stewart were among those consulted.

Q: Did the Bank have a marketing department as such then?

Cavanaugh: The marketing department was built up then, yes, with Mr. Tucker and then later Mr. Dunstan, and then later, of course, Mr. Martin. But the majority of the work was done and the majority of the decisions was made by Mr. McCloy and Mr. Black.

I think that the next step we took was a soul-searching as to what was the best mechanism for selling bonds. Was it the agency approach? Was it the competitive-bidding approach? Was it the underwriting approach? Was it negotiated underwriting or a syndicate underwriting without having a specific set group, where you had various groups form and come in and bid or advise you, at least. And then there was a question of a sponsoring-group approach.

The second time we sold bonds was in 1950, and we decided that it should be tried on a competitive-bidding basis because we felt that it was certainly easier for the Bank and we didn't have to set a price and set a yield. You let the market, at least the dealers, determine what they felt was a good price. This was a very successful thing as far as the Bank was concerned price-wise. We sold some two-percent serial bonds at about par. The underwriters bought them at par and a half, a little more than that actually. This was the cheapest long-term issue we ever sold. However, there was a prestige factor connected with handling our bonds, and the group in Chicago, headed by Halsey Stewart in Chicago, probably paid too much for them and, unfortunately, the market broke immediately after the offering of the bonds and they had difficulty selling them. This put a restriction on our ability to sell through competitive bidding again. The fact that the dealers had gotten hurt with a competitive-bidding issue made them a little leery of trying it again. It probably could have been done again and might have worked out very successfully over the long run. It does work successfully in a lot of railway and other issues, but once some system has some stigma on it, it makes you less willing to want to fuse that system because it might cost you more. So, the Bank then looked for other ways of doing it, and in 1951, when it again sold some 25-year bonds, it used the sponsoring-group arrangement with Chase Manhattan Bank, First Boston, C.J. Devine, and Solomon Bros. and Hutzler as the sponsoring group to sell this. This, again, is a different type of agency arrangement really, where these people put their name on it as recommending it in effect. Whereas in the first issue it was strictly a dealer's selling without in fact recommending the issue as such. A sponsoring group adds to that merely a prestige factor, that these people think they're willing to put their name on as sponsoring the sale. The sponsoring-group arrangement was carried on for another issue in 1951, and that time the sponsoring group was headed by the First National Bank of Chicago and Halsey Stewart. Halsey Stewart had led the group through competitive bidding and got hurt.

This had defects, the sponsoring-group arrangement and the agency arrangement in that as long as you keep changing this group you lose a consistent desire on the part of the dealers to develop a market and maintain a market for your bonds. Also, it's not an underwriting. I mean, it doesn't take the Bank off the hook until the bonds are actually sold to the public. So that, obviously, from the Bank's standpoint, we wanted to get out the bonds to the dealers, either through competitive bidding or through a negotiated underwriting. As competitive seemed to be out of the question, and less desirable, then in 1952, when we put out the next issue of bonds, we went into the underwriting arrangement. Prior to this issue in '52, Mr. Black decided that we should stick to two leading underwriters to head the underwriting syndicate.

This was a difficult choice to make. Mr. Black felt that if you had one, this had advantages to us in that they would be more likely to keep our bonds constantly in their bonds. It was very difficult to narrow it down to two, let alone to one. Two underwriters heading the syndicate and alternating between the ones which would do it, again eliminated a number of leading underwriting houses who were hurt because we selected First Boston and Morgan Stanley as the two to head our syndicate for, we intended, forever, or at least for a long time to come.

But the advantages to the Bank of doing this were finally understood, I think, by the other dealers; they accepted it with good grace in most cases, but I'm sure that Mr. Black had many difficult moments in trying to explain to the various underwriting groups why we were narrowing it and why we were going to limit the leaders to these two, and why they weren't in on it, and so forth. But this system has been followed since then as far as U.S. bonds are concerned.

I think that broadly covers the U.S....

Q: Before we leave the U.S. market altogether and talk about the market abroad, I wonder if you could say a bit more about the problems of getting legislation changed, both Federal and State.

Cavanaugh: I think the only thing I could add really to what we already talked about is to mention the fact that many of the state legislative members and many of the supervisory authorities in the states had been in those jobs for long periods of time and had seen actually the losses that resulted because of defaults of foreign issues and had had their own fingers burned. Therefore, some of them were very difficult to talk to even; they just weren't interested in listening to what was the difference between what we were trying to do and going to do and the safety behind our issues that hadn't existed in these issues that had gone into default. And many of them just from having had a bad experience previously just couldn't believe that there was any merit in authorizing widows and orphans to buy World Bank bonds.

Q: Which were the really important states though? Aren't there only about half a dozen that would account for the great bulk of institutional investments?

Cavanaugh: Yes, obviously, the lower New England states and the Middle Atlantic states were the big ones, plus Illinois, I would say and California.

Q: And with the exception perhaps of Illinois and California, all of these had changed legislation as the Bank wanted by July of '47.

Cavanaugh: No, I don't think all of them had. I'm trying to remember the timing on this. I honestly don't remember the timing well enough to tell you which ones hadn't by July, '47, but some of them had not. I think Illinois had. I think we were all right in Illinois at that time.

Q: Well, let's discuss the market abroad.

Cavanaugh: Well, the market abroad was obviously a smaller market at that time and still is than the U.S. market, when taken individually. In the United States we started with a 250-million-dollar borrowing at one time. In Canada 15 million is a big issue for anybody but the government. In England, again, you'd find that a 25-million-dollars equivalent would be a very big issue there, and, in fact, the Government of the U.K. has never been willing for us to put out an issue of that size, or of anything larger than that. There have been some other issues in the past larger than our issues in the U.K. but five million pounds and 10 million pounds were about all they were willing to think of, and in the beginning 5 million was the amount that they had agreed to. Our desire to borrow abroad probably was largely based on the desire to have non-dollar currencies to lend to our borrowers because these were not convertible currencies and more easily obtainable by our borrowers. And, thus, as we did discuss previously, to the extent that we could supply our borrowers with non-dollar currencies made it easier for them to repay and, thus, made it possible for us to lend larger sums.

Q: As I recall, in some cases the Bank actually sold bonds of a given country before that country released its 18-percent subscription.

Cavanaugh: Yes, some of the countries felt that for budget reasons, for example, they were not in a position to make all of their 18 percent currency available. They couldn't get up the cash internally. From a foreign exchange standpoint, they were willing to let us convert the local currency into foreign exchange but they didn't have the local currency to raise in the government. So that if we sold to the public, if the public was willing to buy our bonds, then that was all right; they could afford to do that.

Our first borrowing abroad actually was in Switzerland when we placed privately with some of the banks 17 million Swiss francs, short-term bonds, which is about four million dollars. And, then, in 1950 we also went to Switzerland and borrowed from the four leading banks 28-and-a-half million Swiss francs, which is about six million dollars. This was a somewhat larger, but still a short-term, issue; it was a six-year serial, whereas the other was a five-year serial issue. No, I guess they both were six years. Yes, they both were six years.

Then, in June of 1951 we sold our first public issue abroad and that was in the U.K. where we sold five million pounds, and there we did it through an underwriting group headed by Baring Bros. Baring Bros. has headed each of our issues in the U.K. We've had the three issues: the one in 1951, and then another one in 1954 and another one in 1959.

Q: These were on an underwriting basis?

Cavanaugh: All of them on an underwriting basis. The reason we haven't had more primarily is based on the fact that the U.K. didn't feel it could afford to export capital and, therefore, limited what we could borrow there. Recently, another factor is involved, and that's the question of cost. The interest rates recently have been higher in the U.K. than in other countries, and sufficiently higher than the U.S. market to make it undesirable for us to borrow in the U.K.

Getting back to the Swiss market for a moment, the underwriters there have been headed by three banks who alternate: the Union Bank of Switzerland, Credit Suisse, and the Swiss Banking Corporation. And these three alternate in heading our underwriting syndicate. In Switzerland we've had an issue almost every year since 1951, a public issue, and in some years we've had two issues. They normally were 50 million Swiss-franc issues, but sometimes were as much as 100 million Swiss francs. Interest rates generally in Switzerland I think have probably always been lower than elsewhere, and therefore we were always willing to borrow in Switzerland and our limitation is the limitation placed by the Swiss Government and who definitely limit the amount of foreign borrowers, foreign borrowings in Switzerland, and they make up their own lists as to who is going to get on that borrowing list. They try to have enough different ones to keep the various customers, and we're probably the only ones that get on every year. There's nobody else that does.

Q: Can you say roughly in point of time when the Bank became more interested in the costs of the borrowings than in a particular currency it was going to borrow?

Cavanaugh: Well, the cost was always a factor. We were never willing to pay too much. By that I mean that the U.S. was the place where we knew we were going to borrow most of our money because it was the only big market. Therefore, we had to be guided by rates in New York. Obviously to the extent that we could borrow anyplace else cheaper than we could borrow in New York, we wanted to do it. But when it came to a question of paying more than we would have to pay in New York, there's probably an unregistered but certainly a--well, I don't know what you call it, but normally we think in terms of--at least I think and Mr. Black thinks--one percent as being the difference we're willing to pay. Now, anything over one percent just isn't thought of, has never been thought of. At the present moment, I would say that the spread is a half of one percent we're willing to pay. For example, today we would not be willing to pay more than five percent abroad, certainly not more than five and a quarter at the most, and it would cost us to borrow here something between four and a half and four and three-quarters. Initially, we were willing to pay one percent more merely because we are an international organization and we wanted to establish our ability to borrow in the various markets, and the fact that we could borrow there made it cheaper to borrow elsewhere, including the United States. And so we went into the Swiss and the U.K. markets. We then in 1952 went into the Canadian market for a 15-million-dollar issue, and in 1954 we went into the Dutch market. In 1958 we went into the German market and in 1959 into the Belgian market and then just this year we've gone into the Italian market.

The timing of when we went into each of these markets was largely when the government said we could borrow, but the price factor is what it is elsewhere. In Canada, for example, probably the main reason we haven't had more issues there is the fact that it costs much more. The interest rates have been enough higher in Canada to keep us out of there. In Germany today and for most of the last year or so we've stayed out of that market because of price. I think the primary reason we've stayed out of the Dutch, Belgian, Italian and U.K. markets recently has been--well, in the U.K. again it's been largely price but the others it has largely been a question of the governments' willingness to let us borrow.

Q: What interests me particularly is the fact that in some of your very earliest borrowings abroad you were interested in getting that particular currency in order to ease the repayment problems of the country that was going to borrow that particular currency. Nowadays, when many more currencies are convertible, I take it that this is no longer a significant factor, and that cost has become almost the sole factor in determining where the Bank borrows.

Cavanaugh: That's true. Cost, plus the governments' willingness to let us.

Q: I was just wondering if there's a particular time when it appeared to you that it was no longer necessary to think of borrowing a particular currency because of the ease of repayment involved.

Cavanaugh: Well, I think this happened together with convertibility, that as the countries late in the '50s began to make their currencies convertible then the fact that a certain borrower was earning, say, in sterling, if sterling was convertible, then we could lend them dollars.

Q: Now, as I understand it, even before the Bank started borrowing the local currencies in various European countries, it had sold directly or indirectly some dollar bonds.

Cavanaugh: When you say before, it wouldn't have been much more before. You see, we started borrowing Swiss francs in '48. Obviously, some of the 1947 bond issue we placed was sold abroad, but not much of it because not many foreign institutions had dollars available. In most cases, foreign institutions had to turn over all of their foreign exchange holdings to the central bank. In Switzerland, of course, this wasn't true, and so some of the New York agencies of Swiss banks probably bought some of our bonds. Some foreign insurance companies probably bought some of our early bonds. And we've always tried to sell dollar-bond issues on as broad a basis as possible and, as you know, we have two special issues of dollar bonds which are sold very widely and designed particularly for central banks, and they're sold in 30 or 40 or 50 countries each time. We have also borrowed dollars from a number of non-American, non-United States institutions, the Bundesbank and several other European institutions who are willing to lend us dollars.

Q: Wasn't there an interesting story in connection with some Dutch underwriters who bought dollar bonds outright and then in turn sold trust certificates or something like that for guilders?

Cavanaugh: Yes. We've always tried to get our bonds listed on the exchanges of various countries. In some countries, this has been easy, such as in Mexico, Turkey; they can just list the dollar securities as such. In other countries, such as Holland, as you mention, this was not possible. So, what happened was that some of the Dutch banks bought 10 million dollars of our first U.S. bond issue actually, the 25-year bonds, and then they issued to Dutch citizens guilder certificates, which really were trust certificates which the banks issued saying, "We, the banks, own some U.S. dollar World Bank bonds. Here's a guilder certificate showing that you, the purchaser, have a part of these bonds that we hold." These are not widely traded abroad. We've listed them in France, in Belgium; there's some trading in these countries but it's very limited. There's very little in Mexico, I'd say, and very little in Turkey and in Italy and in some other places. They aren't listed actually in Italy. But we have paying-agency arrangements in these various countries, so that if a holder of a U.S. dollar bond of ours presents this bond in France or in Belgium, they'll get their money right then and there and get it in local currency. In France they will get it in francs at the rate of exchange, since we pay a fixed dollar amount of interest on the bond. That amount of interest is then converted into French francs that at that time these dollars will buy. So, it does protect the holder there against the exchange risk of the franc devaluing.

Q: So that if the franc were devalued, the French bank that actually held the dollar bonds would have to increase the amount of francs it must pay to the holders of the bonds.

Cavanaugh: That's correct. And so, you would find that these dollar bonds were quoted in France usually at a much higher price than you'd find them quoted in New York. This varies from time to time, depending on what the investors value as the risk of devaluation of the French franc.

I think I might mention also that in all these other countries we use the underwriting technique. In Canada there are three security houses: The Dominion Security, A.E. Ames, and Wood Gundy, who alternate in selling our issues in Canada and Leading the syndicates. In Holland, Netherlands Trading always leads the syndicate. In Belgium, it's Societie Generale. In Germany it's the Deutschebank. In Italy it's the Bank of Italy. This is the only case, Italy, where the central bank actually heads the syndicate. We debated doing this in Germany where also it would be possible to do it because of who we are, but we decided not to do it in Germany. Naturally, the private underwriters don't like to have you do it, but in Italy we felt it was the preferable way of doing it.

Q: What has been the role of the Bank in making it possible for foreign governments to get into the New York bond market directly, either with or without the guarantee of the Bank?

Cavanaugh: The Bank always encourages foreign governments to try to borrow elsewhere and does all that it can to help them. We have made joint operations. At the time we would make a loan to a borrower, they would put out an issue in the New York market, and we would take the long maturities, longer than we normally would, and let the market take the shorter to help sell the issue, because the investors, naturally enough, prefer shorter maturities to the extent that they can get them. We've also helped them with advice as to how to do this, although we are not willing to say you should go to this underwriter or that one. We tell them whom we think are good ones and they usually know who are the good ones. And a lot of them had had contacts in many years past with certain underwriters and naturally we say go to them. And the underwriters know enough about us now and know enough about the borrowers to be willing to do it. I think we probably have told underwriters a number of things about the country and the economic development of the country which has helped the underwriter make up his mind as to whether he would underwrite an issue for them or help them sell an issue and what price to pay.

Q: Are these issues that are sold directly in the market likely to be related to the same projects that the Bank is also financing?

Cavanaugh: There have been many cases, and in other cases they are different projects that are financed by the market. But, normally, when it's a different project, then the timing of the public issue and of our lending is different. I mean, a number of countries go through a period when they can start borrowing in the market but can't borrow everything, and therefore our loans merely supplement what they can borrow in the market and they're not necessarily related, such as in Australia. Australia has been able to borrow in the market on their own and without tying in directly with us, but in many cases the initial going into the market was related to a bond issue of ours, such as in Belgium, Norway and Italy and Austria, and even Japan. The last Japanese issue was for a different project entirely than for what we loaned. We had told Japan that we would only lend this money if they went to the market and got approximately an equal amount from the market.

Q: What happens if the Bank sells some of its own borrowers' obligations in the market?

Cavanaugh: Well, initially, we had to sell this with our guarantee. We found that the fear of foreign lending was a very strong fear until 1955 or thereabouts, but as we sold with our guarantee and the purchasers got their money back without the guarantee being called on, they became confident and they started to buy parts without our guarantee, and we gave them a higher yield when they borrowed without a guarantee, usually one percent at least more.

Q: In other words, they're buying at a discount.

Cavanaugh: Not necessarily. Under our loans we have a right to get any interest rate we want on a bond we ask for, up to the full interest rate on the loan. So, in the beginning there was a big difference between a short-term interest rate and a long-term interest rate, and the purchasers nearly always wanted the short-term. We would make a loan, say, at four and a half percent, and we might sell the early maturities at two and a half percent. That didn't mean that we were selling at a premium necessarily; we might have sold at par because of our right to get the coupon rate on the bond that we wanted. We could get a two and a half percent coupon rate on the bond. Later, when interest rates flattened out, and short-term rates were at one time even higher than long-term rates, then it became necessary to sell at a discount if we wanted to sell at a given yield, higher than the interest rate on the loan. But we did sell with our guarantee up until about '55 or '56, and then as we found that we were able to sell without our guarantee because people began to gain confidence in our borrowers and they were able to get a higher return for their money, then we dropped the guarantee entirely and said we won't sell with our guarantee. Then, it was after that that the interest rate picture flattened out so that it wouldn't have been possible to do this later because we couldn't have made the differentiation below par of one percent or so more for a nonguaranteed piece of paper.