International Liquidity*

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Fifteen days ago, the Prime Minister of Great Britain, Mr. Harold Wilson, devoted a section of his major public speech in New York to consideration of international liquidity. He took the view that the world should push forward promptly in comprehensive planning to avoid a liquidity squeeze which might result from the disappearance of the United States balance of payments deficit.

Some weeks ago, President de Gaulle suggested that the world should return to a gold standard system, and Mr. Jacques Rueff, a well-known French economist, has recently proposed the same course of action, with the additional suggestion that the price of gold be doubled in order that reversion to a gold standard system might take place without drastic deflationary consequences for the world economy.

The President of the German Bundesbank, Karl Blessing, recently endorsed the present international monetary system but suggested the possible desirability of standardizing the composition of national reserves by agreeing on an appropriate ratio between holdings of gold and reserve currencies.

Former Secretary of the Treasury Douglas Dillon in his last press conference suggested that one of the major questions with which his successor would have to wrestle would be that of the future adequacy of world liquidity. Secretary Fowler has agreed "that the greatest challenge in this area is to work out a steadily improving international monetary system so as to facilitate a continuing expansion of trade and economic development in the Free World".

The United States position with respect to the liquidity issue has been made very clear by President Johnson, who said in his Message to Congress on the Balance of Payments:

> The measures I have proposed in this message will hasten our progress toward international balance without damage to our security abroad or our prosperity at home. But our international monetary responsibilities will not end with our deficit. Healthy growth of the Free World economy requires orderly but continuing expansion of the world's monetary reserves.
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> During the past decade, our deficits have helped meet that need. The flow of deficit dollars into foreign central banks has made up about half of the increase in Free World reserves. As we eliminate that flow, a shortage of reserves could emerge. We need to continue our work on the development of supplementary sources of reserves to head off that threat.
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> We must press forward with our studies and beyond, to action—evolving arrangements which will continue to meet the needs of a fast growing world economy. Unless we make timely progress, international monetary difficulties will exercise a stubborn and increasingly frustrating drag on our policies for prosperity and progress at home and throughout the world.

Today I would like to discuss with you just what it is that all of these distinguished people are talking about and why there is this general and widespread interest in international liquidity.

We might start with a very simple statement as to the purpose of international reserves. Their primary purpose is to permit a country to ride through any balance of payments deficit while making an orderly adjustment of its international and domestic policies to restore balance of

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payments equilibrium. In this, the purpose of international reserves is very similar to the purpose of individuals and businesses in setting aside and holding liquid assets for an emergency. A complication with which I shall not deal today is that international reserves in many countries play an additional role as partial determinants of the domestic money supply.

International reserves, of course, are not held in the same form as the reserves of a private business. The traditional reserves of nations are gold and reserve currencies. A reserve currency, if you will excuse the tautology, is a currency which, by general agreement, nations are prepared to hold in their reserves. The dollar is today the major reserve currency. The pound sterling is held rather widely, particularly by sterling area countries, and the French franc is regarded as a reserve currency in some parts of Africa. Each nation makes its own decision as to what it will regard as a reserve currency. It bases its decision on the extent to which that currency can be widely used in international transactions, the confidence it has in the stability of that currency in terms of gold and in terms of goods, and the ease with which it may invest and disinvest both its working balances and additional holdings of the currency in question.

The status of the dollar as a reserve currency developed over the years, particularly since the Second World War, from the voluntary decision of many countries that this was the currency which best met their needs as a reserve asset. The reserve currency status of the dollar is greatly buttressed by the fact that the United States is the only country which stands ready to deliver gold at the fixed price of $35 an ounce to foreign monetary authorities upon request.

But international liquidity has broader dimensions than gold and reserve currencies. When representatives of the Group of Ten leading industrial countries began a couple of years ago to study what has come to be called the "liquidity problem", they placed emphasis upon a broad liquidity spectrum which shaded from owned reserves through certain credit availabilities.

It was agreed that the first additional asset to be included in the broader liquidity concept should be the "gold tranche" position of member countries in the International Monetary Fund. The International Monetary Fund has 102 member countries, and each of these has a quota for which it has paid one-quarter in gold and three-quarters in its own national currency. As a result, one-quarter of its quota in the Fund is referred to as its "gold tranche" rights. Any member country is entitled to borrow from the Fund, virtually without question, any currency it may need up to the amount of its gold tranche position. There is general agreement, accordingly, that the aggregate of gold tranche positions in the Fund, amounting to approximately $4 billion, should appropriately be considered an element in international liquidity. I might mention parenthetically that such gold tranche positions will be increased to $5 billion when the 25 per cent increase in Fund quotas now under way has been completed.

There are other forms of international credit about as liquid as gold tranche positions in the Fund. In the last four or five years, a network of short-term credit facilities has been created among monetary authorities and central banks of the highly industrialized countries. These are generally referred to as "swap" lines. They consist of agreements that the authorities of one country will make its currency available to its swap partners up to agreed amounts, usually for an initial period of ninety days. If, for example, Italy should find itself in need of dollar currency, it could deposit lire to the account of the Federal Reserve System and the Federal Reserve System would deposit an equivalent sum in dollars to the credit of the Italian authorities. These agreements represent a highly liquid asset for the countries concerned. Swap lines can be activated on only a few hours' notice, and many of them have been so activated throughout the network in many directions in recent years. The total of swap agreements at the present time throughout the network amounts to more than $2½ billion.

Another substantial element in international liquidity is represented by special Government bonds which the United States has issued to certain of its creditors in recent years to help finance the United States balance of payments deficit. These may be denominated in the currency of the holder and are convertible at short notice by the holders into cash. Foreign currency bonds now outstanding amount to $1.1 billion. Foreign monetary authorities holding these bonds regard them either as part of their reserve assets or as an asset similar to reserves.

In considering international liquidity, it is also appropriate to take into account the availability of credit from the International Monetary Fund beyond the gold tranche positions. As I have said, one-quarter of a country's quota represents its gold tranche; the full quota itself represents the drawing rights beyond the gold tranche. These borrowing rights are not so automatic as gold tranche drawing rights and, hence, not so highly liquid. Consequently, they are not generally regarded as *reserves*. However, they are available in accordance with well understood standards and have been widely used for many years. They represent an important element in total international liquidity.

The report of the Deputies of the Group of Ten, re-

leased in August of last year, following their study, brought out several interesting points relative to the growth of international liquidity, as the report defined it, during the ten years from 1954 to 1963. As noted, they dealt with international liquidity as being a spectrum divided into two broad categories: "reserves" and "credit facilities". The dividing line between these two closely related classifications was fixed in this manner. Credit availabilities that had not been utilized were, broadly speaking, treated as "credit facilities", and these might be available to potential deficit countries in the future, subject to individual credit arrangements. Reserve assets represented the claims of creditor countries that had been established by the extensions of credit to others in the past on their part, through the International Monetary Fund or directly, and that could readily be mobilized for their own use in case they, in their turn, needed foreign exchange resources. This latter category included also the gold tranche claims on the Fund acquired by past subscriptions of gold to the IMF.

During the ten-year period, the reserves of all the countries in the Free World rose about $17 billion or nearly a third. Gold accounted for nearly $6 billion. Foreign exchange, principally in the form of dollars and sterling, rose nearly $8 billion, and $3 billion was contributed by increased claims on the Fund and by the use of bilateral credit facilities.

You will note that only about a third of the total addition to reserves, defined broadly to include the reserve assets noted, was provided by gold. At the end of 1963, countries held in their reserves about $40 billion in gold or about 57 per cent of the total reserves of $70 billion. $25 billion was held in the form of foreign exchange, one-half in sterling, and one-half in dollars. These foreign exchange holdings were official reserves and take no account of some $15 billion in liquid assets held by non-official private entities, almost entirely as claims in dollars or sterling.

Apart from the global picture, it is useful to pause a moment to look at the regional aspects of this growth in reserves. During the ten-year period, the eight major non-reserve currency countries of the Group of Ten and Switzerland acquired $18½ billion of reserve assets, or $1½ billion more than the world as a whole. This group of countries includes the major part of a persistent surplus area in Continental Europe, which has had an unexampled prosperity and an unprecedentedly strong balance of payments position. Moreover, this group of countries acquired nearly $11 billion in gold, nearly twice the total of new gold supplies available for monetary use in the world as a whole. They were able to do so through a substantial redistribution of the gold reserves of the United States.

This was the pattern of the ten years prior to the study undertaken by the Group of Ten in 1964. Against this pattern, the Ministers and Governors concluded that, "For the international monetary system as a whole, supplies of gold and reserve currencies are fully adequate for the present and are likely to be for the immediate future. These reserves are supplemented by a broad range of credit facilities. The continuing growth of world trade and payments is likely to entail a need for larger international liquidity. This need may be met by an expansion of credit facilities and, in the longer run, may possibly call for some new form of reserve asset."

The Ministers and Governors of the Group of Ten then took several decisions looking toward the future of the monetary system. They undertook a thorough study of the measures and instruments best suited for avoiding and correcting large and persistent international imbalances, compatibly with the pursuit of essential internal objectives. They recommended a procedure for "multilateral surveillance" of the ways and means of financing balance of payments disequilibria. Looking further into the future, since there was a possibility that the supply of gold and foreign exchange reserves may prove to be inadequate for the over-all reserve needs of the world economy, they authorized a study group to examine various proposals regarding the creation of reserve assets either through the IMF or otherwise. Finally, they agreed that they would support a moderate general increase in quotas of the IMF.

It might be asked why there was so much concern regarding the future of international liquidity when reserves had increased so rapidly in the previous ten years. The eight members of the Group of Ten and Switzerland nearly tripled their reserves during the ten-year period, 1954 to 1963. In fact, some of these countries consider that the growth in their reserves has been excessive and has been a contributing factor to inflationary pressures on the European Continent. Thus, they are particularly concerned that the growth in reserves not be excessive in the future, as a result of continuing deficits in the United States balance of payments.

At the same time, they join with the United States in recognizing that there may be conditions in the future, given the remarkably vigorous expansion of world trade and investment, when annual supplies of new monetary gold would alone be insufficient to provide an adequate secular growth in reserves. You will recall that new gold supplied only about one third of the ten-year growth in reserve assets.

The United States also looks forward to a changing

situation; it is not in our interest to continue substantial balance of payments deficits, to pay out increasing amounts of dollars to the rest of the world, and then to be faced with financing a substantial part of that deficit in gold because other countries no longer wish to accumulate important amounts of dollars in their reserves. There is certainly no fixed or absolute level or ratio of our short-term dollar liabilities to our gold reserves. But officially held dollar claims of a liquid character are now just about equal to our gold reserves. They have been rising for about fifteen years, and rising quite sharply since 1958. It is quite essential that we bring this long series of balance of payments deficits to a halt. In doing so, we will also stop the process of providing gold and dollar reserves to the rest of the world.

When this happens, there may then be a question as to how to provide supplementary reserves in some form, to add to gold and the existing holdings of dollars and sterling exchange. It is, in my view, unrealistic to assume that the world can or should attempt to do away with these existing foreign exchange holdings. The gold exchange standard in itself is a useful and meritorious instrument. But, at the same time, we must exercise moderation in its use, and realize that it has been overstrained by the size and persistence of United States deficits, and the resulting supply of dollars.

It is no secret that some European countries feel that the long-continued deficit of the United States has been at best made possible and at worst encouraged and stimulated by the ability of the United States to finance a very substantial portion of its deficit during the past seven years by paying out dollars that have been added to foreign reserves. If the United States deficit had been settled entirely in gold, they assert, the United States would have taken earlier and more rigorous steps to bring its payments into equilibrium.

Accordingly, some of these countries are prepared to argue that the international monetary system at the present time is experiencing a surplus of liquidity, not a shortage. This is perhaps the basis for the suggestion of President de Gaulle that the world should return to a gold standard system. A return to a gold standard would imply a sharp curtailment of world reserves and world liquidity and would carry the threat of worldwide deflation. I need not—for this audience—spell out the detailed mechanism by which this would come about. I mentioned Jacques Rueff, who recently expressed his support for a return to the gold standard in public statements in the United States. Recognizing that this alone would create dangerous deflationary pressures, he couples his proposal with the suggestion that the price of gold be doubled and that the United States then pay off its liquid liabilities to foreign central banks in gold at the new price. That would mean redeeming some $14.5 billion of dollar reserves of foreign official holders at a rate of $70 for an ounce of gold rather than the existing $35 per ounce. The United States would be left at the end of the operation with gold reserves near the present level, according to the new valuation, and would have wiped out its official liabilities to foreign monetary authorities.

Such a proposal is thoroughly unacceptable to the United States. It combines the proposal that the world once again accept automatic regulation of its money supply according to the vagaries of world gold production with the proposal that the implied and stated commitments of the gold exchange standard be repudiated to the advantage of a few and the disadvantage of many. It is easy to see how it might be appealing to the major gold-producing countries, including the Union of South Africa and the U.S.S.R., and to some countries holding a high proportion of their reserves in gold. It would, of course, be discriminatory against countries which have kept a substantial fraction of their reserves in the form of reserve currencies. Our commitment to maintain the fixed parity of $35 an ounce between gold and dollars is basic to the stability of the world monetary system. President Johnson has reiterated our unchanging determination to maintain this parity.

We share fully, however, the European view that our balance of payments deficit should be promptly corrected. We do not believe that the existence of the present monetary system has weakened our resolve to eliminate our balance of payments deficit. We have, however, insisted that the deficit be eliminated by measures which would have a minimum impact both on the rate of economic growth in our own country and on the continued economic prosperity of the rest of the Free World. We have ruled out measures which would have denied our responsibilities in defense of the Free World or in the economic development of less developed countries—and we have done so in the interest of free men everywhere. Our deep reluctance to adopt more restrictive monetary or fiscal policies at home has derived from the unshakable conviction that a strong and growing economy in the United States is a prerequisite both to lasting correction of our balance of payments difficulties and to continued prosperity in the Western world.

I shall not digress at any length to review the extent to which our balance of payments position has, in fact, been strengthened in recent years. The splendid record of price stability which we have maintained through fifty months of steady economic growth has established for us a strong

competitive position in world trade and our trade balance is highly favorable. We have reduced the balance of payments impact of our military and foreign aid operations without retreating from our commitments in these areas. More recently, measures have been taken to dampen the outflow of capital from the United States by means of the voluntary cooperation of the banking system and the business community. The United States will, however, continue to be an important source of productive capital.

Before I resume commenting briefly on what I think will be the principal issues to be decided as we cooperate in working out arrangements to assure that adequate world liquidity will be maintained when our deficit has been corrected, I should acknowledge that there is a school of thought—and one which appears to be quite strong in academic circles—that believes in solving the liquidity problem not by increasing liquidity but by reducing the need for liquidity. Members of that school are the advocates of floating exchange rates. They hold that fixed exchange rates alone create the need for large reserves. More importantly, perhaps, they feel that fixed exchange rates constitute a restraining influence preventing individual countries from following domestic policies which might be deemed appropriate for domestic aims. If exchange rates were free to move up and down in the market, a balance of payments deficit would be reflected in a cheapening of the country's currency rather than in a loss of reserves. The cheapening of the currency, in turn, the argument runs, would bring about adjustments in the trade pattern—lower imports and higher exports, among other changes—which would restore balance of payments equilibrium. No country would need to hold large reserves and each country could choose its internal monetary and fiscal policies according to its own system of priorities and without regard for balance of payments effects.

I am not going to try to argue the case for or against floating rates. I would admit, as any student of economics will admit, that the theoretical arguments for floating exchange rates can be presented with great precision and appeal. Operation of the system in a world of imperfect knowledge, imperfect governmental and monetary institutions, and conflicting national ambitions and policies would be something else again. I will merely express the opinion, which is shared by an overwhelming majority of commercial and financial interests, that such a system, in practice, would prove extremely disruptive to world trade and financial transactions. The Ministers and Governors of the Group of Ten have ruled out consideration of any such system and the International Monetary Fund has operated for nearly twenty years in defense of a regime of generally fixed exchange rates, with individual exchange rate adjustments regarded as appropriate from time to time when individual countries have fallen into a position of fundamental disequilibrium.

As we consider possible methods for assuring adequate liquidity in the future, the next question is whether some new *type* of asset should be created or whether liquidity needs can be met by further development and refinement of existing credit mechanisms.

On the credit side, agreement has already been reached, in principle, on a 25 per cent increase in International Monetary Fund quotas. I say "in principle" because, while more than 80 per cent of the membership favored the increase, each member must now determine for itself, in accordance with its own legislative procedures, whether it will accept its appropriate share of such increase. The United States Administration is seeking Congressional approval for an increase of $1,035 million in the United States quota. The House of Representatives voted favorably on this bill on Tuesday of this week. We are confident that the total of aggregate quotas in the Fund will be increased from about $16 billion to about $21 billion when this operation has been completed. That will provide an appreciable addition for international liquidity in the form of credit facilities.

The most intriguing aspect of the liquidity question, however, doubtless lies in efforts to devise a new type of reserve asset. I mentioned that the Deputies of the Group of Ten, in their Report to Ministers, announced that they had established a "Study Group on the Creation of Reserve Assets" to study the problem which its name implies. The Group is meeting periodically. It is expected to present to the Deputies some time this summer a study which will "assemble the elements necessary for evaluation of the various proposals" which have been put forward.

I cannot speak in detail about the work of this Group. But its terms of reference are public information. The Deputies to the Group of Ten spoke of two types of proposals:

> One, the introduction, through an agreement among the member countries of the Group, of a new reserve asset which would be created according to appraised over-all needs for reserves;
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> and the other based on the acceptance of gold tranche or similar claims on the (International Monetary) Fund as a form of international asset, the volume of which would, if necessary, be enlarged to meet an agreed need.

Proposals of the first type vary substantially in detail. Essentially, however, these schemes provide that a limited group of countries, by depositing their own currencies or gold, establish a central pool of monetary resources which would provide the backing for a new reserve unit. Members would receive in exchange for their respective subscriptions an equal value of reserve units. These would represent proportionate claims upon the aggregate pool of resources and these claims or units would be transferable among the members in settlement of surpluses or deficits. The reserve unit itself would be held or used much as gold is now held in reserves or used in international settlements. By agreement among the members, it would assume the nature of gold; it would be held as reserves; its value would be fixed in terms of gold; and its acceptance by any member would be automatic according to stipulated conditions.

For example, some proposals would call for creation of a limited amount of reserve units and for the use of these units in fixed proportion with gold in making all settlements among members. The economic effect would be little different from the gold standard itself. It would operate like the gold standard with some reserve units added. Like a return to the gold standard itself, it could call into question the continuing usefulness of reserve currency holdings and would probably encourage the conversion of some holdings into gold. To the extent such conversions should occur, the world would face a decline in total world liquidity, rather than an increase.

A second important condition would be that dealing with the manner in which decisions would be made for increasing or, if necessary, decreasing the amount of units in existence. To oversimplify, it would be in the apparent interest of creditor countries to resist—and of debtor countries to favor—the creation of additional units. If new issues were to be subject to a unanimous agreement, which is to say if any country could veto an expansion or a contraction, it would hardly be accurate to say that decisions regarding the adequacy of international liquidity had been placed under international control in any meaningful way.

The importance of the conditions which might govern creation of new assets would be no less if new reserve assets should be created in the International Monetary Fund. Proposals of this type call for creation of claims on the Fund that can be drawn upon at will to meet balance of payments deficits. For example, automatic drawing rights could be accorded against some part of the existing credit tranches in the Fund. Another proposal is that the Fund might be authorized to invest some of its holdings of currencies in member countries, thereby providing those countries with assets usable internationally.

Again, a number of questions would have to be considered. Would operation of the normal weighted voting procedures in the Fund serve the interests of creditor and debtor countries equitably? Should reserve assets be created for all countries or for only those countries that might be expected to be in both surplus and deficit over a period of years?

However additional reserves are created, their use implies a credit operation. The original creation could take the form for each participating country of an equal increase in its liabilities and in its assets—the latter becoming, by terms of the agreement, an international reserve asset. There would be no real economic impact at this stage. But as soon as the newly created asset or unit began to be used, those surplus countries which accumulated the unit would be extending credit to the deficit countries. And the extension of credit from one country to another reflects the transfer of real assets. The surplus country foregoes present consumption in exchange for higher reserves—or for future potential consumption. A creditor country has, of course, considerable freedom of action in controlling the credit it will extend. There are many acceptable ways in which a balance of payments surplus can be reduced. Study of the adjustment process to determine appropriate policies to be followed—both by deficit countries to correct their deficits and by surplus countries to reduce their surpluses—is another area to which the Group of Ten is giving attention.

With respect to the deficit countries, no country can expect to receive unlimited automatic credit from its trading partners. The search for assurance that adequate international liquidity will be maintained in the future will not in any sense be a search for automatic credit for persistent debtors.

I have mentioned a few of the issues connected with the liquidity discussions without giving any clear indication of what the answers should be. The answers must await continued hard study and, at an appropriate stage, perhaps hard negotiations. I will advance only three questions for your consideration at this time.

First, how can we make certain that any new scheme will be entirely compatible with the evolution of the existing system? This will require that nations should not be penalized—nor benefited—as a result of the composition of their reserves, when and if some new liquidity asset is developed.

Secondly, how can we assure that any new system will increase and not reduce world liquidity? World liquidity would be reduced to the extent that existing reserve currency holdings are converted into gold. What, then, should be our attitude toward proposals which might stimulate

such conversion or cast doubt upon the stability or the convertibility of existing reserve currency holdings?

Thirdly, how can we make sure that any new system will maintain machinery for giving appropriate weight to the views of both creditor and debtor countries? Should it be subject to the arbitrary control of either, or to the veto of a single country?

These are three broad questions, among many, that will need to be kept in mind as we proceed to examine most carefully the various ideas that have been or may be suggested. We are conscious that the creation of any new type of reserve asset by international agreement would be a step of profound significance. We must be sure that it is a step in the right direction. The mechanism of the international monetary system is an intricate and complicated mechanism, the successful functioning of which is of worldwide concern. We must make certain that any adjustments made in that mechanism will be the best that experience and intelligence and concern for the welfare of all nations can devise.