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A NEW LOOK AT LIQUIDITY

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A New Look At Liquidity

I am delighted to have this opportunity to renew acquaintance with this particular group of Robert-Morris Associates. It is hard for me to realize, and to accept, the fact that I last talked to this group in Asheville North Carolina, at your Spring meeting in 1948--some 16 years ago! I was then talking on the Marshall Plan, in a setting in which the United States was bending every effort to supply the dollars needed for European reconstruction, and when the rest of the free world seemingly was confronted with a chronic "dollar shortage." In that first phase of postwar monetary developments, the international monetary problem was to restore the strength of the currencies of the war-damaged countries, to make them convertible once again, and to dismantle the many trade and payments restrictions that had been erected. During this phase, which ended with the restoration of the convertibility of the currencies of the major countries in 1958, the United States adopted numerous methods to avoid a surplus in our balance of payments--so as not to deplete further the inadequate liquidity, in the form of scanty gold and foreign exchange reserves, of the rest of the world. Thus, we provided more than enough credits and grants to finance our export surplus. We encouraged other countries to spend the proceeds of this assistance elsewhere than in the United States. We countenanced import restrictions in Europe and elsewhere which discriminated against U.S. exports. And in formulating domestic policies we did not have to be particularly concerned with their effect on our balance of payments. These and other policies were all designed both to improve the balance of payments of other countries and to strengthen their currencies relative to the strength of the U.S. payments balance and the U.S. dollar.

Since the restoration of currency convertibility in 1958, we have really been in a second phase of postwar monetary developments. In this second phase the by-products of success of the earlier policies were evident in the form of sizeable payments surpluses in Europe and correspondingly large payment deficits here. The result has been a substantial growth in the gold and dollar reserves of continental Europe and Japan. During this period, the United States has had to reappraise and slowly change policy approaches designed for the earlier phase. Perhaps we have sometimes been too cautious in making adaptations, but we have always been conscious of the impact of our policies on the rest of the world. Thus, we have consistently refused to do those things that would solve our balance of payments problems but which would have been disruptive of world trade and payments.

As we continue in this second phase to make progress in reducing the substantial deficits in the U.S. balance of payments and move back closer to equilibrium, continental Europe, Japan, and the rest of the world can expect to experience a slower growth in reserves from this source. Thus, the questions to be faced in the new third phase in postwar monetary developments toward which we are moving are: what form should the necessary degree of future expansion in world liquidity take? What future changes, if any, are desirable in the international monetary system to adapt it to the disappearance of large U.S. deficits--deficits that created a large part of the world's growth in liquidity?

In an attempt to answer these fundamental questions, there has been intensive study during the past year, in a number of different quarters, of international liquidity and the international monetary system. Thus, my subject today really should be entitled "New Looks at Liquidity." For at and following the annual meetings of the International Monetary Fund and International Bank for Reconstruction and Redevelopment in Washington a year ago, several "looks at liquidity" were initiated.

To begin, the Ministers and Governors of the so-called "Group of Ten"--the ten leading industrial countries participating in the General Arrangements to Borrow--initiated a study by their Deputies of "the outlook for the functioning of the international monetary system and its probable future needs for liquidity." The study was undertaken largely at the initiative of the United States which recognized that, in the long run, the contribution of additional dollars to world reserves would not continue as in the past, and also felt that it was most appropriate for representatives of leading countries, representing a substantial share of the resources of the International Monetary Fund, to search for principles that would be relevent to the quinquennial review of Fund quotas already scheduled under the Fund's Articles of Agreement. At the meetings last year, it was indicated that the International Monetary Fund also would undertake a parallel study of liquidity. And shortly after the close of that Washington meeting, 32 economists from the Group of Ten countries, plus Switzerland, organized themselves under the chairmanship of Professor Machlup of Princeton University to carry out a study under private auspices centering on the same general subject.

By the time of this year's annual Bank-Fund meetings, held in Tokyo just a month ago, the results of these studies had been published. On August 10, 1964, the Ministers of the Group of Ten issued a statement, appending a summary of the main results of the studies by their Deputies (generally a Treasury official and central bank representative from each of the countries participating) reflecting exhaustive discussions in a series of monthly meetings held throughout the year, usually in Paris. The parallel IMF study on international liquidity was included in its 19th Annual Report published on the same date in August. And the International Study Group of private economists had also reported on its labors in a monograph published in August.

I do not intend today to try to make a full sweep of the findings of all of these studies, but rather to give you some of the flavor and substance of the two official studies--the Group of Ten and IMF studies--which formed the focal point of many of the addresses and much of the discussion at the recently concluded Tokyo meetings. It seems to me of considerable significance--more probably than has been generally realized--that, despite the complexities of the area covered in these studies, understandably leading to divergences in national viewpoints, each of the two official studies reached definite conclusions on a number of important points and, on the main points, were in substantial agreement. Before going into these areas of agreement, however, perhaps it may be appropriate to outline the character and forms of international liquidity that we are talking about.

Sometimes I am tempted to philosophize that liquidity is in no small degree a state of mind. Certainly one of the significant aspects of all of the studies this past year has been, in my judgment, a greater recognition and understanding of the many facets of liquidity.

The international monetary system includes, and depends upon, the banking facilities and practices under which individual exports, imports, and other private transactions are financed. The emphasis in the studies, however, was not on these private financing practices--which work well, with few squeaky wheels--but on the means of financing the over-all balance of payments positions of the participating countries. For international liquidity simply consists of <u>all</u> the resources that are available to monetary authorities for the purpose of meeting balance of payments deficits.

Balance of payments deficits--and the corresponding surpluses--can be financed either by a transfer of international reserve assets (mainly gold and foreign exchange) from deficit to surplus countries or by the extension of credit directly by the surplus country or through an international institution. Both studies of international liquidity usefully developed a clearer concept of the entire spectrum of financing facilities, from reserves owned outright to negotiated credits.

While gold remains the basic international asset, it has been importantly supplemented by holdings of foreign exchange--mainly the dollar--and by a wide range of credit facilities. For the world as a whole, gold makes up about 60 per cent, and foreign exchange holdings about 40 per cent, of owned reserves. Over the past decade increasing foreign exchange holdings--mainly dollars--have accounted for almost 60 per cent of the growth of reserves.

Closely akin to these reserves in the liquidity spectrum is another reserve asset that is receiving increasing attention. Here I am referring to the so-called "gold tranche" positions of member countries in the IMF. These are drawing rights at the Fund, acquired by a country as a result of previous gold payments to the Fund or of use of its currency in Fund loans to other countries. These drawing rights are useable on a virtually automatic basis and, therefore, are virtually the same as "owned reserves." The United States financed a large part of our deficits in recent years out of just such claims.

Further along the liquidity spectrum are various types of assets resulting from earlier credits extended by individual countries (such as utilized swaps and Roosa bonds). Then come committed credit lines (such as IMF standby credits and central bank standby swaps). Finally there are potential credits from other countries or international institutions (such as ordinary IMF credits) which are frequently referred to as "conditional liquidity," since their availability may depend upon the borrowing country meeting certain conditions concerning its policies.

Against the background of this brief digression on the liquidity spectrum, the main points brought out by these "new looks" at liquidity by the Group of Ten and Fund are:

First, the two studies agree that the existing international monetary system has worked well thus far, in the sense it has the capacity for adaptation, has facilitated record growth, and has withstood periods of considerable strain.

Second, both studies, taking into account a recommended and prospective increase of Fund resources, concluded that liquidity was fully adequate for the present, so that any liquidity problem was a future not a present one.

Third, there was recognition of the close inter-relationship between the need for liquidity and the speed and efficiency of the process of adjusting imbalances. Inevitably the many transactions between countries--more specifically between the individuals, businessmen, traders, and financial institutions of the various countries--result in imbalances in total payments between countries. It is the function of international liquidity--both reserves and credit--to finance these inevitable imbalances, until they are reversed either by normal more-or-less automatic processes or by deliberate policy measures. The process by which surpluses or deficits are reversed has come to be called the "adjustment process." It is widely recognized, and was emphasized in both the Group of Ten and the Fund studies, that there is a close, two-way connection between the adjustment process and the amount of international liquidity needed.

Recognizing these inter-connections, one of the major recommendations in the Group of Ten report was that Working-Party 3 of OECD undertake a study of the adjustment process of correcting imbalances in international payments processes, with a view to determining appropriate policies for avoiding or minimizing such imbalances. In assigning this task to Working-Party 3, which is composed of financial officials of governments and central banks, the intent was clearly not to have an abstruse academic analysis of the adjustment process, but rather to take advantage of the involvement of Working-Party 3 in the day-to-day appraisals of what is currently happening--the events that typify the way in which the adjustment process is actually working--to test out the possibility of determining criteria or standards of adjustment.

Related to this problem of improving the adjustment process, the Deputies and Ministers of the Group of Ten called for "multilateral surveillance of bilateral financing and liquidity creation"--basically nothing more nor less than a decision among the Ten to exchange information more promptly and regularly regarding means of financing any surpluses or deficits. As Chancellor Maudling pointed out at the Bank-Fund meetings this is "intended to represent a step forward along the road of increasing consultation and cooperation in monetary and economic affairs which we have been following ever since the end of the war." From the United States' standpoint, too, this process represents a formalizing and strengthening of existing international cooperation, particularly with respect to reporting arrangements. It will permit more informed, and useful, appraisal in Working Party-3 and among the central bank Governors. It does not, as Chancellor Maudling pointed out, "give any member of the Group of Ten, or indeed the Group as such, a veto on the setting up of new facilities within the Group or between members of it, or on the use of existing facilities. It does, however, recognize very clearly that arrangements made between individual countries may well be of close interest to other members of the Group, and that the interest of these other members should be taken fully into account when new arrangements are made."

<u>Fourth</u> and finally, both official studies recognized that the continuing growth of world payments is likely to entail a need for larger international liquidity in the future. As the Ministerial Statement of the Group of Ten points out "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 IMF occupies a central position with respect to both types of liquidity. As far as the immediate expansion of international credit facilities is concerned, the Group of Ten report called for a moderate general increase in Fund quotas, supplemented by selective increases for those countries whose quotas are clearly out of line. At the Tokyo Bank and Fund Meetings, there was universal support for such a general increase in quotas, with some expressing the view that it should be limited to 25 per cent and others obviously feeling that a larger percentage would be more desirable.

The general move toward a quota increase began in Tokyo with a clear call by IMF Managing Director Schweitzer for an increase, followed by Secretary Dillon's supporting statement--the latter intended to be a statement of basic position which would prepare the way for action in the Fund next year. The call for quota increases met with support from many of the other Governors in their prepared statements, and culminated in the adoption by the Fund Governors of a draft resolution to the effect:

> "That the Executive Directors proceed to consider the question of adjusting the quotas of members of the Fund and at an early date submit an appropriate proposal to the Board of Governors."

One important unresolved question related to the proposed quota increases is that of the gold payments (normally 25 per cent of the quota increase) to accompany such increases in subscriptions, and the resultant possible impact of such gold payments on reserve currency countries, and on aggregate world reserves. With trade and payments expanding more rapidly than the supply of monetary gold, it is especially important that there be economy in its use. Since the United States is the only country maintaining gold convertibility--the foundation of the present system--and therefore is apt to be called upon by many countries making gold payments, it is especially significant that the Group of Ten and Fund reports called attention to the need for looking at methods of minimizing the impact, particularly on the reserve currency countries, of transfers to the Fund of gold from national reserves.

There are several ways in which this impact might be mitigated. One that has been suggested is to simply spread out the quota contribution over two years or so but this would clearly be an inadequate solution. An important part of any mitigation should, of course, be the payment of their gold subscriptions by principal countries, certainly those which have been accumulating gold in recent years, out of their own present holdings. In addition, there are other possibilities indicated in the Fund's Annual Report which would involve the Fund shifting some of the gold back, e.g., either by deposit or investment. Another answer, perhaps the best one, is to have at least part of the gold payment in gold notes payable on demand--in essence representing subscribed but uncalled gold.

As to the possible creation of new forms of reserve assets, the conclusion of the liquidity studies thus far is that the matter calls for further study. The Group of Ten has set up a special "Study Group on Creation of Reserve Assets" specifically for this purpose. The IMF made no formal recommendation on this question either but its report contained a discussion of various techniques whereby the Fund might create and vary the supply of reserve assets carried by its members.

I might take a moment to run over the major alternative proposals that have been put forward for adding to owned reserves in the future. One proposal is for the creation, by a limited group of industrial countries, of a new reserve unit - referred to as a collective (or composite) reserve unit. Such a unit could be created by one of a number of different techniques but its basic characteristic, as proposed, is that it would serve as a supplement to gold in the reserves of this group of countries and in the financing of payments imbalances among this group of countries. Each country of the group would agree to hold the new unit in fixed proportion to its gold holdings. Thus if one country in deficit sold gold to the others, collective reserve units would also be transferred, in fixed proportion to the amount of gold transferred.

One of the advantages claimed for this approach is that it would provide an "objective" means of creating reserves in place of what the French Finance Minister and Dutch central bank Governor described in Tokyo as an undesirable system, in which the creation of owned reserves is linked to changes in the balance of payments of the reserve currency countries.

A second, and related, advantage of this system is said to be its greater stability. In contrast to dollar reserves, which are convertible into gold by foreign monetary authorities, the proposed unit would not be so convertible but would itself be useable only in rigid relationship with gold. One of my associates describes it as "instant gold" or "alchemist's gold."

The United States has expressed its open-minded willingness to explore this and other proposals. But, as Secretary Dillon stated in Tokyo, we see serious problems in this approach. First, and fundamental in our view, is the U. S. belief in a "multilateral framework" for handling problems of world liquidity. If a new reserve unit were to be created it ought to be considered by and available to a broader group of countries than the 10 or 11 leading industrial nations.

Second, there is a danger that the collective reserve unit approach, with its rigid link to gold, would be much too restrictive--that is, would provide an inadequate amount of reserves and would therefore induce countries to restrict trade and domestic economic activity.

Third, and basic to all of our discussions of liquidity, is our healthy scepticism as to whether the needs of the future will call primarily for an additional reservoir of owned reserves created to meet supposed global needs, which is the essence of the French proposal, or whether the real need of the future may not be, as it is currently, for an expansion of credit facilities in response to specific balance of payments requirements, and a greater recognition of the potentialities of the Fund. Even if an expansion of owned reserves in the future becomes necessary it can be done most appropriately within the framework of the International Monetary Fund. The member countries of the IMF are becoming increasingly aware that, as I have indicated, a new type of reserve asset already exists in the form of the "gold tranche" positions in the Fund. These "gold tranche" positions represent drawing rights acquired by a country, either as a result of paying gold subscriptions into the Fund or by virtue of the Fund lending out the currency of a member country in surplus to a member country in deficit, thus increasing the surplus country's "gold tranche" position.

Other alternative proposals that have been put forward for study also involve adapting the IMF to meet any possible future needs for additional owned reserves. Surplus countries might, for example, be permitted to deposit their own currencies in the Fund and receive the equivalent of a "gold tranche" drawing right as these funds are drawn by other countries. This suffers the obvious drawback of not assuring in any systematic way the creation of needed amounts or forms of liquidity. Another possibility suggested in the IMF report would involve Fund investment operations, the purchase by the Fund of assets in order to add to countries' reserves. In short, there are a number of possibilities, all of which need and deserve careful study, for creating reserve assets by the further development of the institutional arrangements already established in the International Monetary Fund.

All of these, and any other, alternative possibilities of necessity must be scrutinized in the light of such basic questions as their compatibility with the existing system, their merits as a contribution to a greater stability of the international monetary system, their ability to direct liquidity to the point of greatest legitimate need at any given time, their ability to adapt the volume of reserves to global needs as opposed to individual shortages, the acceptability of the claim they offer as a reserve asset, their effect on relationships among countries and finally, their more than mechanical problems of the machinery required for controlling the volume and distribution of reserves so created.

Let me stress, however, that all of the ideas I have mentioned are very much in the exploratory stage and for the most part are designed to meet hypothetical situations that may or may not arise. But the world does not stand still and I believe that it is of significance that so much time and effort is being devoted to explorations preparing for possible future contingencies. And let me invite you to join in the exploratory process. There is no reason why, as we enter the third phase of postwar monetary history, the United States or any other country should be fearful of further innovations in international monetary arrangments--as long as those innovations are, as they have been in recent years, in response to real needs and represent a reasonable, useful, and natural evolution of the present system, which has served the world so well.