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THE GREAT LIQUIDITY DEBATE

Remarks by J. Dewey Daane

Member, Board of Governors of the Federal Reserve System

at the Luncheon Meeting of the

Joint Boards of Directors

Federal Reserve Bank of Chicago & Detroit Branch

Detroit, Michigan

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Introduction

When I was teaching Money and Banking some years ago at the University of Richmond Evening School, I had a rather motley group of students including one middle-aged woman claiming to be some kin to Senator Harry Byrd. After class one evening during which I had laboriously explained how the multiple expansion in bank deposits worked, she came to me and, after remarking on the fact that I was the Monetary Economist at the Richmond Reserve Bank, asked me to explain what happened to her friend's savings, totaling some $10,000, that had been lost in a bank failure in Richmond in the early 1930s. I explained to her that the contraction of bank deposits operated just like the expansion and that with banks liquidating assets as in the '30s, the money supply (bank deposits) contracted. Her reply to me was, "Yes, Dr. Daane, I understand all of that but what come of that money?" When we were talking about a possible topic for my remarks to you today some of my colleagues suggested, "What Come of that Gold?" instead of the less illuminating title, "The Great Liquidity Debate". But international liquidity is not really unrelated to the more exciting story now unfolding with respect to the U. S. balance of payments position, program, and prospects, and also not unrelated to the current question of the gold outflows which we have been experiencing. For international liquidity is really nothing more nor less than all the resources which monetary authorities can muster to finance balance of payments deficits. And as long as the U. S. continues to experience balance of payments deficits, we can expect to have some gold losses as part of the liquidity which we use in paying for these deficits. Simply stated, the magnitude of those gold losses depends on whether or not the surplus countries such as France, etc., want gold in settlement to add to their own liquidity in that form.

In turn, one of the questions frequently put to me is whether new sources of international liquidity might not make it possible for the United States or for other countries to ignore the discipline of the balance of payments. This is a misconception which I think needs clarifying. No likely amount of international liquidity or money magic can solve, or enable indefinite postponement of efforts to solve, a chronic balance of payments problem. Yet, the recent calls from abroad for reform of the international monetary system, and for some new form of reserve asset to provide international liquidity, stem in part from a suspicion, often voiced, that the United States has taken undue advantage of its position as a reserve currency country to finance its deficit with unwanted dollars and, consequently, has been able to avoid the harsher measures that a country in deficit presumably should be taking--particularly measures in the monetary sphere. The answer, of course, to the charge lies in the continous and increasingly comprehensive efforts made to contain the U. S. balance of payments deficit, beginning in February 1961, accelerated in mid-1963, and broadened in February of 1965--efforts which have not ignored the monetary area. In fact the latest measures have a very direct and conclusive impact on bank lending abroad.

The focal point for my remarks today, however, is not the U. S. balance of payments but rather what I have chosen to call "The Great Liquidity Debate". Thus, in the short time we have this noon I would like to talk with you about three questions--What is the present international liquidity debate all about? Where is it taking place? What of the future, and specifically, does it represent a break in the international financial cooperation that has been the hallmark of the post-war international monetary system?

Forums for discussion of liquidity

Taking the easiest question, the "where" question, first, there have been various forums in which international liquidity has been either consistently in the center of the stage or always and ever-present in the wings. First, and very appropriately, it has occupied much attention in the International Monetary Fund, and that attention is reflected in the Fund's last Annual Report issued this past August. Second, the whole matter of international liquidity, and the role of gold and the dollar in supplying that liquidity, have been the subject of intensive studies and debate in the so-called Group of Ten, or their Deputies, representing the ten leading industrial countries which agreed in the fall of 1961 in their General Arrangements to Borrow to supplement the resources of the IMF.

Although the debate broke more into the open with the speeches over the past 6 months or so by General de Gaulle and French Finance Minister Giscard d'Estaing, the main issues in the debate have been with us right along in our studies in The Ten, beginning in the fall of 1963. At that time the Finance Ministers and Central Bank Governors of the Group of Ten called for a study of the functioning of the international payments system and "its probable future needs for liquidity." As a result, the Deputies of the Group of Ten, with each country generally represented by a senior treasury and central bank official, met almost monthly during the year between the International Bank and Monetary Fund annual meetings in the fall of 1963 and their Tokyo meetings last fall. The findings of their study were incorporated in the Ministerial Statement and Deputies Annex of the Group of Ten issued last fall prior to the Bank-Fund meetings.

Another forum not specifically directed toward liquidity, but inevitably involved in the debate, is Working Party-3 of the Economic Policy Committee of the OECD (Organization for Economic Cooperation and Development). The OECD, which is a successor to the former OEEC originally designed to advise on the distribution of Marshall Plan aid, consists of some 21 countries, including all of the Western European countries, plus the United States, Canada, and, more recently, Japan. The OECD has as one of its plenary committees an Economic Policy Committee which provides for regular review of current economic trends in the member countries, study of their changing economic problems, and consultation on appropriate courses of action. Its meetings, which usually take place at intervals of three or four months, enable the senior officers responsible for advising upon economic policy in their respective countries to exchange ideas, forecasts, suggestions and criticisms. This Economic Policy Committee, in turn, has a number of working sub-groups and Working Party-3, on the balance of payments, is undoubtedly the most notable of these.

Working Party-3, which meets normally in Paris about every six weeks, was established in early 1961 in large part as a reflection of a new initiative on the part of the United States in the field of international monetary cooperation. Like the Deputies of the Ten group, and with membership largely overlapping, it consists of senior officials of central banks and Ministries of Finance in those ten or eleven countries whose actions have the greatest influence on international payments. Its task is to analyze the effect on international payments of monetary, fiscal and other policy measures in the member countries, and to hold consultations on policy measures, both national and international, as they relate to international payments equilibrium and to the financing of payments imbalances--and specifically, to provide for "multilateral surveillance" of the latter. Thus, although their attention is primarily directed toward payments positions, international liquidity is of vital concern to Working Party-3.

Finally, the last, but by no means the least, of the several forums are the meetings of the central bankers in Basle, Switzerland, almost every month, under the aegis of The Bank for International Settlements. Again, while these meetings provide for frank and intimate discussions among the western world's leading central bankers of a wide range of problems of mutual interest, international liquidity inevitably cannot be readily detached from their deliberations and discussions.

I have discussed these forums with you at some length because they are vital not only to the liquidity debate but to the international financial cooperation which we, along with other countries, have been experiencing and benefiting from in recent years. For the problem of international economic cooperation is, to a very significant extent, a problem of communication: for each country, one of giving the representatives of other countries a better understanding of its problems and the reasons for its policies and, in turn, of gaining better understanding of their problems. Recently I had the privilege of hearing Professor Chandler of Princeton University discuss his study of the working of the gold exchange standard in the inter-war period between World War I and World War II; he stressed the conclusion from his study that a lack of communication had been a major weakness leading to the breakdown of that system. Thus, the development of communication and understanding in various forums has been, in my judgment, a major achievement in the building and strengthening of our world payments system.

The issues in the liquidity debate

Turning to the "what" of the international liquidity debate, from the outset of our studies the areas of substantive agreement and difference have been apparent.

First, as to the areas of agreement--or what the liquidity debate is not about--it was clearly recognized and reiterated by the Group of Ten that fixed exchange rates and the present established price of gold had proved their value as a foundation on which to build for the future.

Second, the debate is not about the present adequacy of liquidity--the ten countries agreed in a judgment that international liquidity, defined as the entire spectrum of resources available for financing payments imbalances, and taking into account a recommended and prospective increase in IMF quotas, is fully adequate for the present and near-term future. To reinforce this the Group of Ten Report called for a moderate general over-all increase in Fund quotas, plus selective increases for those countries whose quotas are clearly out of line. As you know, these increases are already in process of implementation and will result in a $5 billion increase in IMF resources--from $16 billion at present to around $21 billion. This will significantly increase the Fund's resources in usable currencies which have fallen to relatively low levels. It will place the Fund in a stronger position to cope with expanded credit needs associated both with the substantial enlargement of the world economy that has taken place since the last general increase in quotas in 1959, and with the larger needs of a convertible currency world.

A third area in which there was, and is, general agreement is that the need for liquidity depends on the speed and efficiency with which countries reduce or eliminate imbalances, either surpluses or deficits, in their balance of payments positions. Thus, there is no debate about the need to examine this so-called adjustment process with a view toward possible improvement; it is widely recognized, and was emphasized in the Group of Ten Report, that there is a close, two-way connection between this adjustment process and the amount of international liquidity needed. The trick, of course, is to insure that the international financial system can and will provide individual countries with enough liquidity to facilitate an orderly process of adjustment, without recourse to undesirable inflationary or deflationary actions or "beggar-my-neighbor" policies, but not so much as to enable countries to ignore the need for internal adjustments to restore equilibrium.

Recognizing these inter-connections, the Group of Ten report recommended that Working Party-3 of OECD undertake a study of the process of adjustment involved in correcting imbalances in international payments, with a view to determining appropriate policies for avoiding or minimizing such imbalances. This review is already under way in a special study group under the aegis of Working Party-3, looking at such questions as the balance of payments objectives of individual countries, the differing policy problems presented by different kinds of balance of payments situations, and the various policy instruments and measures related to the process of adjustment.

Turning to the disagreements, what is the liquidity debate really all about? First, the debate began by revolving around the question of the kind of liquidity needed as we looked ahead to the future functioning of the payments system. There was a division in emphasis at the outset in appraising future liquidity needs, specifically as to whether what might be needed primarily was an increase in so-called "owned reserves," now mainly gold and foreign exchange holdings, or in credit facilities. In a sense, this was the early core of the debate for it was the French view, and to a lesser extent perhaps that of the Dutch and some of the other European countries, that reserve assets should no longer be created by continued extension of credit to reserve currency countries, that further expansion of reserve currency holdings should not be the source of future liquidity, and that therefore some new form of reserve asset was needed and should be created to supplement gold. The United States' view has fully agreed that gold might not be enough to do the trick, and that dollars could not be expected to furnish liquidity in the same way as they did in recent years while we were in payments deficit. But it was our belief that under the foreseeable circumstances it was still important to have adequate credit facilities to deal with the fluctuations that undoubtedly will continue to affect the balance of payments of major countries. Thus, the United States welcomed the useful increase in Fund quotas now being implemented. In addition, drawings on the Fund usually result in the addition of reserve assets for the country whose currency is drawn since they give that country a readily usable gold tranche claim on the Fund. Similarly, bilateral credit facilities, such as Federal Reserve swaps, represent additions to reserves as long as they are utilized and outstanding. But perhaps even more could be done in the development of multilateral credit facilities, especially since the advent of the multilateral surveillance process now carried out in Working Party-3.

From the outset of the liquidity studies there also has been a willingness to explore the question of the form and mechanism of creating reserve assets to supplement gold and reserve currencies in supplying possible future needs if and when there is a clearly felt need for a new method of reserve creation. The United States joined, without prejudgment or commitment, in the setting up by the Group of Ten of a so-called "Study Group on the Creation of Reserve Assets" to make a study of the various alternatives; this study group in which the United States is participating is in process and continuing. Among the alternatives, of course, is the proposal for a Collective Reserve Unit (CRU). Another major type of proposal is the further development of gold tranche or similar claims on the International Monetary Fund as an international reserve asset, and the deliberate creation of such assets for reserve purposes rather than as a by-product of normal drawings.

At this stage there seems to be little point in reiterating the various objections to the CRU scheme. A major concern on our part has to do with its gold link and possible contractive impact on liquidity as The Ten, and non-Ten countries also, would have a new incentive to convert other reserve assets into gold, and its generally restrictive approach toward accommodating expanding world needs. It also has seemed more appropriate for reserve asset creation to be kept within the familiar International Monetary Fund framework.

Possible basic questions re reserve asset creation

Rather than try to argue either side of the debate over particular proposals for reserve creation, however, it might be more useful to try to suggest a few of the basic questions, as I see them, that may prove to be important in any search to find the right method of reserve creation to supplement the existing system.

(1) A first question is that of the adaptability of the reserve asset creation process to the complex world in which we live and the differing needs of different countries.

We live in a world of diversity. Even among the relatively homogeneous Group of Ten nations, there are marked differences in the size of individual countries, the absolute magnitude of their foreign transactions, and the proportion of these to the domestic economy, their economic objectives, the condition of their domestic economies at any particular time, their economic institutions, the refinement of their financial structures.

The existence of such differences is a fact which the process of liquidity creation should recognize and accommodate. Rigid methods should be avoided and new approaches should be capable of adaptation to differences among countries at any given time and to the evolution of monetary needs over time.

(2) A second question is that of the closeness of the relationship of any new asset to gold, either in its creation or in its use. Both in domestic and international finance, the historical tendency has been toward the increasing use of substitutes for gold. It would appear to be a retrograde step to establish a new form of international money rigidly linked to gold, and usable only in conjunction with gold.

In this connection, it is useful to distinguish between the short-run problem of achieving acceptance for a new reserve asset and the longer run problems that arise when it has become accepted. Some gold-linked proposals have an appeal because such a link assures original acceptability. But such initial acceptability is purchased at a cost: as long as the asset can be used only with gold, a significant portion of the new assets will in fact be immobilized, since countries will not want to run down their gold holdings.

In any event, once a reserve asset has become generally accepted, a loss of reserve assets in the form of the generally-accepted new unit has just as much disciplinary effect on the deficit country as a loss of gold.

(3) A third and important question is whether a new reserve asset would be detrimental to existing liquidity. A very high percentage of existing liquidity represents reserve currency holdings, and the attitudes of their holders are a vital concern in constructing an acceptable reserve asset that would add to, and not subtract from, present liquidity.

(4) A fourth question is whether in creating new international reserve assets the market function of the dollar is sufficiently recognized. Apart from its role as a store of value, the dollar is the major vehicle currency in the world. All countries, even if they hold few dollars as permanent reserves, use dollars in exchange operations and therefore need working balances in dollars. By the same token, surpluses and deficits show up initially as accumulations or reductions in dollar holdings.

(5) Fifth, there is the question of countries to be included in any future scheme for reserve creation. It has been suggested that such countries presumably should be expected to be neither persistently in deficit nor persistently in surplus. That is to say, reserve creation should not be looked upon as a way of financing persistent surpluses and deficits, though any increase in

reserves is likely to have the effect of making the financing of temporary deficits and surpluses somewhat easier. On the other hand, there is much to be said for an open system; that is, for including in the reserve-creating process as many countries as would qualify, provided they meet reasonable conditions, and for leaving membership open to other countries that might qualify in the future.

(6) Sixth, and finally, there is the question as to how decisions are made as to reserve creation. The procedure for making decisions could have a great deal of effect on the way the reserve creation process operates, and particularly, on its adaptability. One alternative would be to adopt the Fund principle of weighted voting; another would be to require unanimity. A unanimity provision, enabling any member to veto action desired by the rest of the group, would obviously represent a restrictive approach and, as pointed out recently by Under Secretary Deming, could hardly lead to any meaningful internationalized creation of liquidity.

<u>The continuance of international financial cooperation</u>

These observations lead me to my final question as to the future, and specifically as to the continuance of international financial cooperation. As I have indicated, the liquidity studies will be going forward, as they are now, under the aegis of the Group of Ten. My belief is that we will be wrestling with these issues throughout the summer, and beyond, in the various forums I have described, and specifically in the meetings of the Deputies of the Group of Ten. Despite the obvious problems, international financial cooperation is continuing in an effort to solve them. One dramatic illustration is the fact that shortly after the famous de Gaulle Statement, France agreed to join the other nations in renewing the equally famous three billion dollar stabilization package for the British. And subsequently the French discount rate action, although directed toward and consistent with domestic aims, was a further step helpful internationally. Even more significant, however, is the fact that international cooperation is taking place, and will continue to do so, in the several forums which I have mentioned, not only in the IMF and the Group of Ten and their Deputies, but also in Working Party-3 of the OECD, and in the monthly meetings at Basle of the central bankers.

Concluding comments

But in looking ahead I come full circle back to my point of departure which was the link between all of these matters and the clear need to right our balance of payments. On this score I am particularly impressed by the comments in a recent speech by one of the world's foremost non-U.S. monetary authorities. In this speech he stated flatly, "Too large deficits by the reserve currency countries undermine confidence in the present international monetary system. Objective leadership by the United States in the international monetary field will only be forthcoming after that country is freed from direct balance of payments worries." I believe that this is true and that until we have restored equilibrium in our balance of payments we cannot expect to exert fully the leadership in the international monetary field that will be necessary to produce constructive results and solutions to the problem of international liquidity.