For Release on Delivery

(Approximately 7:00 p.m.,
Friday, November 13, 1964)

INTERNATIONAL LIQUIDITY AND ALL THAT

Remarks by J. Dewey Daane

Member, Board of Governors of the Federal Reserve System

Before the Southern Finance Association

Atlanta, Georgia

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In the history of economic thought 1964 may well go down as the "Year of Liquidity". For throughout the world economists and financial officials, many of whom still classify themselves as economists, have been struggling with the question of the possible future needs for international liquidity. And at home more than just side glances have been given to the matter of our domestic liquidity, amidst charges by some Europeans that the liquidity which has proven to be the successful servant of an orderly expansion in the U. S. economy has, at the same time, contributed to excessive liquidity internationally and aggravated problems of inflation abroad.

All of you are, I am sure, familiar with the various liquidity studies that were concluded and published this last August. To begin, there was the study initiated by the Ministers and Governors of the so-called "Group of Ten"--the ten leading industrial countries participating in the General Arrangements to Borrow--a study of "the outlook for the functioning of the international monetary system and its probable future needs for liquidity". Paralleling this was the study of liquidity which the International Monetary Fund included in its Nineteenth Annual Report. And a group of some thirty-two academic economists from the Group of Ten countries, plus Switzerland, carried out still another study, under private auspices.

From all of the ferment of this past year many different concepts and possible measures of international liquidity have come to the fore. These concepts and measures are directly relevant to a number of the proposals currently under review that would provide for such future liquidity problems as might develop. Consequently, they merit exploration and consideration before turning to the questions of the current and prospective adequacy of liquidity and of what form any necessary degree of future expansion in world liquidity should take.

On the conceptual front much progress has been made in delineating the many facets and components of liquidity; in fact, one of the most significant developments in the various liquidity studies recently completed has been a greater recognition that there is in fact a broad spectrum of liquidity, ranging from reserves owned outright--gold and foreign exchange holdings--through assured and readily available credit facilities, and on out to possible negotiated credits. It has been generally recognized in the official studies by the Group of Ten and the IMF that international liquidity consists of <u>all</u> the resources that are available to monetary authorities for the purpose of meeting balance of payments deficits. I might mention parenthetically that the academic group did not go quite the full way in this. The International Study Group of 32 economists, while taking cognizance of the spectrum of assets and borrowing powers, chose to confine their concept of liquidity narrowly to owned reserves and unconditional drawing rights. This seems to me to ignore the fact that balance of payments deficits can be financed either by a transfer of international reserve assets (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--whether the credit is obtained unconditionally or otherwise. Just as domestic liquidity means command over domestic means of payments, so international liquidity means command over international means of payments, however that command may be obtained or arranged.

The essential point is that command over means of international payments includes both the ownership of such means and the availability of facilities that assure the ready acquisition of such means in case of need. While the "owned reserves" and "credit facilities" components of liquidity may have certain overlapping characteristics, the distinction between them has played an important role in the recent liquidity studies and is germane to the issues confronting all of us in our continuing studies of international liquidity.

"Owned reserves" consist mainly of the traditional reserve assets, gold and foreign exchange. But for all practical purposes they also encompass two other types of assets which have only quite recently attained reserve character: the so-called gold tranches of the quotas of member countries of the International Monetary Fund; and the so-called Roosa-bonds.

Gold tranches are, very roughly speaking, the equivalent of the gold component of member countries' subscriptions to the IMF, <u>plus</u>

those amounts of their currency subscriptions that have been used for drawings by other member countries. Members are free to draw on the Fund's resources to the extent of their gold tranche positions virtually without any formality or restriction; this automatic character of gold tranche drawing rights has been emphasized by recent steps to further streamline the Fund's procedures for such drawings. Hence, these tranches are practically the equivalent of a demand deposit, or similar claim, with an international bank. The United States financed a sizeable part of its deficits in recent years out of just such claims, and Italy, too, earlier this year discovered just how useful its gold tranche, representing a build up of credit in the IMF, could be in financing its deficit.

Roosa-bonds are obligations of the U. S. Treasury issued to foreign central banks or governments, most of them denominated in the currency of the creditor country. They are usually redeemable before maturity if the creditor country confronts a payments deficit. Last spring, for instance, Italy had payments troubles. In agreement with the U. S. Treasury, it presented its Roosa-bonds for advance redemption, and used the proceeds for a transfer to Germany; Germany, in turn, converted those proceeds back into new Roosa-bonds. Hence, although the Roosa-bonds themselves are non-marketable, they could be used by Italy to pay a debt to Germany--just as if they had been international means of payments.

"Credit facilities" can be considered part of a country's international liquidity if their availability, even when subject to negotiation, is sufficiently assured that the country can reasonably count on using them in case of need. At present, such facilities include the swap arrangements between the Federal Reserve and major foreign central banks, and the credit tranches of member countries of the IMF.

Facilities under the Federal Reserve swaps are practically identical with mutual credit lines, with predetermined amounts available to either party to the arrangements as circumstances may require. The IMF credit tranches correspond to the part of a country's quota that exceeds the gold tranche. Utilization of IMF credit tranches has various degrees of assurance, ranging from virtual certainty in the case of so-called stand-by arrangements to the need for presenting effective stabilization programs in the case of applications for drawings, or new standby arrangements, on tranches in excess of one-half of a country's Fund quota.

Translating the broad spectrum of financing facilities into the world of fact, what are the real magnitudes of the various components in total world liquidity in the present setting? First of all, looking at the attached table, total world liquidity (official) amounted, at mid-1964, to almost $87 billion, of which about three-fourths represented owned reserves in traditional gold and foreign exchange form and one-fourth other assets and credit availability. Of the traditional owned reserves, gold totaled some $40 billion, or about 60%, and foreign exchange totaled some $25 billion, or about 40%. New types of reserve assets with characteristics similar to owned reserves--gold tranches and Roosa-bonds--added almost $5 billion more.

In addition, credit facilities, in the form of Federal Reserve swaps and IMF credit tranches, totaled slightly more than $16 billion. These absolute magnitudes, however, conceal the increasing reliance on newer forms of liquidity in the growth of the total in recent years. For of the $20 billion growth of total world liquidity since the advent of the era of currency convertibility at the end of 1958, only about two-fifths of the $20 billion increase in liquidity took the traditional form of gold and foreign exchange, while other similar type assets and credit availability accounted for three-fifths.

Against this background of concept and measurement of international liquidity, what about its adequacy? Here we begin to get into very muddy water indeed for there are no adequate criteria of adequacy. Some would appraise adequacy--neither too little, nor too much, international liquidity--as most clearly discernible in the actions of monetary authorities. In their view, international liquidity is adequate if there is prima facie evidence that no country is either taking unduly restrictive steps in the interest of conserving reserves, or following overly expansionary policies by virtue of having recourse to the external liquidity tap. In the light of a recommended and prospective increase of Fund resources, both the Group of Ten and IMF studies, noting the difficult judgments involved and decrying any quantitative formula, concluded that liquidity is fully adequate for the present. If the pace and continuance of economic growth is taken as an indicator, the recent past and present adequacy of international liquidity can hardly be doubted.

While recent past and present adequacy of international liquidity may be demonstrable by record and sustained economic growth alone, future adequacy can be no more than a guess. On the supply side we can make some reasonable forecasts about the future supply of the various components of liquidity. But the demand side is equally relevant, and here we are confronted with two major indeterminate factors; the first, that of attitudes, and the second, that of adjustments.

As to the first, attitudes have much to do with prospective liquidity needs. Sometimes I wonder whether international liquidity is not simply a state of mind. This is much more than a facetious observation because, as we have learned during the past year, attitudes taken toward available assets, such as gold tranches, and other credits are importantly determinative of the adequacy of liquidity and, specifically, of the supposed needs for additional owned reserves. If countries were to become engaged in a competitive race merely to pile up owned reserves and then to protect rather than to use such reserves, future liquidity needs would assume one form and dimension. If, on the other hand, countries chose to maximize the potential usefulness of an existing stock of liquidity by more efficient mobilization, supplemented by a larger and more effective credit mechanism under multilateral review, liquidity needs assume a different shape altogether.

The second major imponderable in forecasting liquidity needs is how smoothly and rapidly the adjustment process works. As we know from the record, the demand for liquidity does not, of necessity, rise pari passu with the growth of international trade. Looking back at the period between mid-1958 and mid-1964 the annual trade volume (exports plus imports) grew from $196 billion to $311 billion, or nearly 60%. From the attached table it may be seen that international liquidity rose only half as fast in that period, from $67 billion to $87 billion, or about 30%. There is no sacrosanct fixed relation between liquidity and rising world economic activity, any more than there is between the money supply and a given rate of domestic economic growth.

More determinative of liquidity needs than the total trade level is 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".

I should hasten to add that while the adjustment process may importantly affect liquidity needs, the reverse does not hold in quite the same way--liquidity cannot for long substitute for efforts of both surplus and deficit countries to correct imbalances. Differences in views about optimum methods and the optimum pace of the adjustment process, however, do color judgments about the role of international liquidity in that process. Limited liquidity may force rapid, and perhaps undesired, adjustment, while rapid adjustment should reduce liquidity needs. Liberal liquidity would permit gradual, perhaps too gradual, adjustment and means, in effect, much higher liquidity needs and supplies. Again this distinction is central to the differences in view between the U. S. and some continental countries regarding a balance of payments program and the role in it of monetary policy.

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, with a view to determining appropriate policies for avoiding such imbalances. A related major recommendation 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 a result, Working Party-3--with the benefit of more current information derived in the multilateral surveillance process--will be undertaking to review possible "rules of the game" that might serve to improve the adjustment process in the more complex world in which economic policies must be flexibly adapted to differing national needs. Much has been said about the diminished role of monetary policy in this process. I would not dispute the point that the same kind and degree of monetary policy actions that may have served the simpler classical model of disequilibrium might not as often be appropriate to the different sort of world in which we live. At the same time we should not lose sight of the fact that monetary policy in the United States, and elsewhere, has played and will, I am sure, continue to play, an important role--with techniques appropriately tailored to both internal and external considerations.

Despite the imprecision of any appraisal of future liquidity needs, the outlook for the various supply components provides impressive assurance of reasonable growth in total world liquidity to meet foreseeable needs over the next few years.

Quite recently, the contribution of gold to monetary reserves has greatly increased; in the first half of 1964 monetary gold accrued at an annual rate in excess of $1 billion, about twice the average of the preceding five years. This high rate is attributable not only to steady expansion of gold production and larger Soviet sales, but, most importantly, to steadily rising confidence in the stability of the monetary system of the free world, deterring speculative hoarding. Continuance of these favorable developments may well result in gold contributing more to international liquidity supply in the period ahead than in most recent years. On the other hand, the contribution of additional foreign exchange holdings to world reserves cannot be expected to continue as in the past. Over the last twelve months, for example, the aggregate of foreign official dollar holdings has not changed. At best, perhaps the future aggregate additions to liquidity from the two traditional reserve assets may be in the neighborhood of the average increase over the past 5 years.

On the credit facilities side, however, which has been providing the necessary expansibility of world liquidity, another major increase in supply in the form of IMF quotas is in prospect. IMF quotas will presumably be raised next year by at least 25%, or some 4 to 5 billion dollars. While further additions to Roosa-bonds and swap arrangements may be modest, the strengthening of cooperation involved in the process of "multilateral surveillance" assures possible further elaboration and use of such bilateral facilities.

Finally, no discussion of future needs for, and supplies of, international liquidity would be complete without recognizing that they are also influenced by the volume of private holdings of foreign exchange. Over the last 12 months foreign private holdings of dollars alone have risen by more than $1 billion, while there has been virtually no increase in the flow of dollars into official reserves of other countries taken as a group, and Western Europe has, on balance, paid out dollars from its reserves. Thus, a substantial part (over three-fourths) of our own deficit, and corresponding need for international liquidity to finance it, has been met by increased holdings of dollars by foreign private accounts, no doubt largely reflecting trade needs. All this means is that the private demand for international liquidity has an important bearing on both present and future needs for official reserves and credit facilities.

The central issue remaining--the issue that undoubtedly will be, and should be, the focus of continuing study by economists within and outside governments--is whether additional owned reserve assets will have to be deliberately created and, if so, what are their possible alternative forms. All of the preceding discussion of concepts, components and adequacy of liquidity is directly relevant to this issue. In the light of this discussion, the first question to be raised is whether a new system for owned reserve creation is likely to become necessary, or whether future needs for international liquidity can, and should, be met largely through the continuing expansion of international credit facilities. As was brought out in Tokyo, during the Bank-Fund meetings, the U. S. clearly looks toward credit facilities to furnish in major part the necessary flexibility and disciplined expansibility to meet future liquidity needs.

As to the possible form of any new reserve assets that might be created, the conclusion of the liquidity studies thus far is that this aspect of the matter calls for further study and, indeed, such study is already in process. 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.

Several major alternative proposals 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 linking of the creation of owned reserves to changes in the balance of payments of the reserve currency countries. A second, and related, advantage claimed for the collective reserve unit system is an allegedly 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 the collective reserve unit approach. First--and this is a fundamental point in our view--it goes against 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 for the use of, 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 our approach to discussions of liquidity, is a 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 collective reserve unit proposal, or whether the real need of the future--so far as new deliberate action is concerned--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 accomplished most appropriately within the framework of the International Monetary Fund. The member countries of the IMF are becoming increasingly aware, as I have indicated, that a new type of reserve asset already exists in the form of the "gold tranche" positions in the Fund.

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.

Crucial to the resolution of the liquidity issue and the orderly evolution of the world payments system is the further strengthening of international financial cooperation, already a notable feature of the progress made in recent years. There is ample evidence of the increased international cooperation that we in the United States, along with our European colleagues, have been experiencing, and benefiting from, during the past several years. In monthly meetings in Paris I have seen at first hand the development of a mutual understanding of the complex problems facing each of the participating countries, an understanding that has provided a broader base for cooperative efforts. Tangible results are apparent in the agreement among the Group of Ten to participate in the "General Arrangements to Borrow", providing a sizeable addition in Fund resources; in the ad hoc, Basle type, arrangements in which central banks have provided assistance bilaterally; in our own network of Federal Reserve swaps and stand-by swap arrangements, now totaling over $2 billion; in the investment of over $1 billion in Roosa-bonds. And the most recent moves toward increased monetary tightness in European countries were tailored as far as practicable, at least, so as to avoid, or minimize, any possible disruptive external effects on other countries. Again, just last week, the Group of Ten agreed in Paris to an activation of the GAB so as to provide supplementary resources to the IMF for use in meeting any drawing by the United Kingdom under its existing stand-by arrangement with the IMF.

I speak with conviction of this matter of international cooperation because I believe that the very process of continuous confrontation--in Working Party-3 and the Economic Policy Committee of the OECD, in the G-10 Deputies and Ministers meetings, in the Basle meetings of central bankers--has been one of the most useful and constructive recent achievements in the international monetary area, and portends successful solution of any future liquidity problems. Simply to be able to sit down and talk directly and candidly with our financial official counterparts in the other leading countries is in itself, in my judgment, a great gain.

As we look ahead to even greater international financial cooperation, with the formalizing of the newer monetary techniques and instruments under the aegis of the "multilateral surveillance" process, any successful choice of a new reserve asset as a possible means of adding to liquidity must be forged out of mutual agreement. And, similarly, without attempting to prejudge the results of the study of the adjustment process, I am convinced that the minimizing of future imbalances will also rest upon the achievement of an even higher degree of international financial cooperation.

This process of mutual interchange of ideas, and mutual efforts to improve the functioning of the payments system, has benefited much from the contributions of economists and others outside of governments. In conclusion, therefore, I would invite you to join in the exploratory process in which we are now engaged in trying to find new solutions to possible liquidity problems. None of us in the United States, or in any other country, should be fearful of further innovations in international monetary arrangements--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.

OFFICIAL RESERVES AND CREDIT FACILITIES
(In millions of dollars)

	Gold	Foreign Exchange	IMF Gold Tranche Positions	Roosa-bonds	Federal Reserve Swaps	IMF Credit Tranche Positions	Total
December 1958	38,030	19,340	2,560	0	0	7,290	67,220
June 1964	40,480	25,240	3,890	950	2,050	14,120	86,730
	+ 2,550	+ 6,100	+ 1,330	+ 950	+ 2,050	+ 6,830	+ 19,510

Sources: Roosa-bonds and Federal Reserve Swaps: Federal Reserve Bulletin

Others: International Financial Statistics, October 1964, pages 16-19 (all figures rounded to nearest 10 million)