

The Dollar and World Liquidity: a Minority View

(with Emile Despres and Walter S. Salant)

Three American economists, each outside government service but each with influence in official Washington, here put forward a dissenting view on the prime current issue of international payments. We believe that the analysis is of profound importance and must be taken into account even by those who would balk at some of the conclusions. Our own remaining reservation is appended briefly.

The consensus in Europe and the USA on the US balance of payments and world liquidity runs about like this:

- (1) Abundant liquidity has been provided since the Second World War less by newly mined gold than by the increase in liquid dollar assets generated by US balance-of-payments deficits.
- (2) These deficits are no longer available as a generator of liquidity because the accumulation of dollars has gone so far that it has undermined confidence in the dollar.
- (3) To halt the present creeping decline in liquidity through central-bank conversions of dollars into gold, and to forestall headlong flight from the dollar, it is necessary above all else to correct the US deficit.
- (4) When the deficit has been corrected, the growth of world reserves may, or probably will, become inadequate. Hence there is a need for planning new means of adding to world reserves — along the lines suggested by Triffin, Bernstein, Roosa, Stamp, Giscard and others.¹

So much is widely agreed. There is a difference in tactics between those who would correct the US balance of payments by raising interest rates — bankers on both sides of the ocean and European central bankers — and those in the USA who would correct it, if necessary, by capital

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restrictions, so that tight money in the USA may be avoided while labor and other resources are still idle. There is also a difference of emphasis between the Continentals, who urge adjustment (proposition 3 above), and the Anglo-Saxons, who stress the need for more liquidity (proposition 4). British voices urge more liquidity now, rather than in the future. But with these exceptions, the lines of analysis converge.

Four counter propositions

There is room, however, for a minority view which would oppose this agreement with a sharply differing analysis. In outline, it asserts the following counter propositions:

(1) While the USA has provided the world with liquid dollar assets in the postwar period by capital outflow and aid exceeding its current account surplus, in most years this excess has not reflected a deficit in a sense representing disequilibrium. The outflow of US capital and aid has filled not one but two needs. First, it has supplied goods and services to the rest of the world. But secondly, to the extent that its loans to foreigners are offset by foreigners putting their own money into liquid dollar assets, the USA has not overinvested but has supplied financial intermediary services. The 'deficit' has reflected largely the second process, in which the USA has been lending, mostly at long and intermediate term, and borrowing short. This financial intermediation, in turn, performs two functions: it supplies loans and investment funds to foreign enterprises which have to pay more domestically to borrow long-term money and which cannot get the amounts they want at any price, and it supplies liquidity to foreign asset-holders, who receive less for placing their short-term deposits at home. Essentially, this is a trade in liquidity, which is profitable to both sides. Differences in their liquidity preferences (that is, in their willingness to hold their financial assets in long-term rather than in quickly encashable forms and to have short-term rather than long-term liabilities outstanding against them) create differing margins between short-term and long-term interest rates. This in turn creates scope for trade in financial assets, just as differing comparative costs create the scope for mutually profitable trade in goods. This trade in financial assets has been an important ingredient of economic growth outside the USA.

(2) Such lack of confidence in the dollar as now exists has been generated by the attitudes of government officials, central bankers, academic economists and journalists, and reflects their failure to understand the implications of this intermediary function. Despite some contagion from these sources, the private market retains confidence in the dollar, as increases in private holdings of liquid dollar assets show. Private speculation in gold is simply the result of the known attitudes and actions of governmental officials and central bankers.

(3) With capital markets unrestricted, attempts to correct the 'deficit' by

ordinary macro-economic weapons are likely to fail. It may be possible to expand the current account surplus at first by deflation of US income and prices relative to those of Europe, but gross financial capital flows will still exceed real transfer of goods and services (that is, involve financial intermediation, lending long-term funds to Europe in exchange for short-term deposits) so long as capital formation remains high in Europe. A moderate rise of interest rates in the USA will have only a small effect on the net capital outflow. A drastic rise might cut the net outflow substantially, but only by tightening money in *Europe* enough to stop economic growth, and this would cut the USA's current account surplus. Correcting the US deficit by taxes and other controls on capital, which is being attempted on both sides of the Atlantic, is likely either to fail, or to succeed by impeding international capital flows so much as to cut European investment and growth.

(4) While it is desirable to supplement gold with an internationally created reserve asset, the conventional analysis leading to this remedy concentrates excessively on a country's external liquidity; it takes insufficient account of the demands of savers for internal liquidity and of borrowers in the same country for long-term funds. The international private capital market, properly understood, provides both external liquidity to a country and the kinds of assets and liabilities that private savers and borrowers want and cannot get at home. Most plans to create an international reserve asset, however, are addressed only to external liquidity problems which in many cases, and especially in Europe today, are the less important issue.

With agreement between the USA and Europe — but without it if necessary — it would be possible to develop a monetary system which provided the external liquidity that is needed and also recognized the role of international financial intermediation in world economic growth.

Europe needs dollars

Analytical support and elaboration of this minority view is presented in numbered sections, conforming to the propositions advanced above as an alternative to the consensus.

(1) The idea that the balance of payments of a country is in disequilibrium if it is in deficit on the liquidity (US Department of Commerce) definition is not appropriate to a country with a large and open capital market that is performing the function of a financial intermediary. Banks and other financial intermediaries, unlike traders, are paid to give up liquidity. The USA is no more in deficit when it lends long and borrows short than is a bank when it makes a loan and enters a deposit on its books.

Financial intermediation is an important function in a monetary economy. Savers want liquid assets; borrowers investing in fixed capital expansion are happier with funded rather than quick liabilities. Insofar as the gap is not bridged, capital formation is held down. Europeans

borrow from the USA, and Americans are willing to pay higher prices for European assets than European investors will, partly because capital is more readily available in the USA than in Europe, but mainly because liquidity preference in Europe is higher and because capital markets in Europe are much less well organized, more monopolistically controlled, and just plain smaller than in the USA. With unrestricted capital markets, the European savers who want cash and the borrowers who prefer to extend their liabilities into the future can both be satisfied when the US capital market lends long and borrows short and when it accepts smaller margins between its rates for borrowing short and lending short. European borrowers of good credit standing will seek to borrow in New York (or in the Eurodollar market, which is a mere extension of New York) when rates of interest are lower on dollar loans than on loans in European currencies, or when the amounts required are greater than their domestic capital markets can provide. But when interferences prevent foreign intermediaries from bridging the gap, and when domestic private intermediaries cannot bridge it while the public authorities will not, borrowing possibilities are cut, and investment and growth are cut with it.

The effects are not confined to Europe, or even to the advanced countries. Slower European growth means lower demand for primary products imported from the less developed countries. Preoccupation of the USA, Britain, and now Germany with their balances of payments dims the outlook for foreign aid and worsens the climate for trade liberalization. And the American capital controls are bound to reduce the access of less developed countries to private capital and bond loans in the USA — and indirectly in Europe.

(2) It may be objected that no bank can keep lending if its depositors are unwilling to hold its liabilities. True. But savings can never be put to productive use if the owners of wealth are unwilling to hold financial assets and insist on what they consider a more 'ultimate' means of payment. If the bank is sound, the trouble comes from the depositors' irrationality. The remedy is to have a lender of last resort to cope with the effects of their attitudes or, better, to educate them or, if neither is possible, to make the alternative asset (which, against the dollar, is gold) less attractive or less available. To prevent the bank from pursuing unsound policies — if it really tends to do so — it is not necessary to allow a run on it. The depositors can have their say in less destructive ways, for example through participating in the management of the bank of last resort or through agreement on the scale of the financial intermediation.

The nervousness of monetary authorities and academic economists is a consequence of the way they define a deficit and the connotations they attach to it. No bank could survive in such an analytical world. If financial authorities calculated a balance of payments for New York *vis-à-vis* the interior of the USA, they would find it in serious 'deficit', since short-

46 *International Money*

term claims of the rest of the country on New York mount each year. If they applied their present view of international finance, they would impose restrictions on New York's bank loans to the interior and on its purchases of new bond and stock issues. Similarly, the balance of payments of the US financial sector consists almost entirely of above-the-line disbursements and therefore nearly equal 'deficits.' Between 1947 and 1964 the liquid liabilities (demand and time deposits) of member banks of the Federal Reserve System alone increased from \$110 billion to \$238 billion. This increase of \$128 billion, or 116 per cent, was not matched by an equal absolute or even proportionate increase in cash reserves. Indeed, these reserves increased only \$1.6 billion, or 8 per cent. Yet nobody regards this cumulated 'deficit' of over \$126 billion as cause for alarm.

The private market has not been alarmed about the international position of the dollar in relation to other currencies or the liquidity of the USA. Although there has been private speculation in gold against the dollar, it has been induced largely by reluctance of some central banks to accumulate dollars. The dollar is the world's standard of value; the Euro-dollar market dominates capital markets in Europe, and the foreign dollar bond market has easily outdistanced the unit-of-account bond and the European 'parallel bond.' As one looks at sterling and the major Continental currencies, it is hard to imagine any one of them stronger than the dollar today, five years from now, or twenty years hence. Admittedly, short-term destabilizing speculation against the dollar is possible, largely as a consequence of errors of official and speculative judgment. It can be contained, however, by gold outflows and support from other central banks, or by allowing the dollar to find its own level in world exchange markets, buttressed by the combination of high productivity and responsible fiscal and monetary policy in the USA. In the longer run, as now in the short, the dollar is strong, not weak.

(3) Since the US 'deficit' is the result of liquidity exchanges or financial intermediation, it will persist as long as capital movement is free, European capital markets remain narrower and less competitive than that of the USA, liquidity preferences differ between the USA and Europe, and capital formation in Western Europe remains vigorous. In these circumstances, an effort to adjust the current account to the capital outflow is futile. The deficit can be best attacked by perfecting and eventually integrating European capital markets and moderating the European asset-holder's insistence on liquidity, understandable though the latter may be after half a century of wars, inflations and capital levies.

An attempt to halt the capital outflow by raising interest rates in the USA either would have little effect over any prolonged period or else would cripple European growth. With European capital markets joined to New York by substantial movements of short-term funds and bonds, the rate structure in the world as a whole will be set by the major financial center, in this instance New York. Interest-rate changes in the outlying

centers will have an impact on capital flows to them. Higher interest rates in New York will raise rates in the world as a whole.

The effort is now being made to 'correct the deficit' by restricting capital movements. Success in this effort is dubious, however, for two reasons.

Money is fungible

In the first place, money is fungible. Costless to store and to transport, it is the easiest commodity to arbitrage in time and in space. Discriminating capital restrictions are only partly effective, as the USA is currently learning. Some funds that are prevented from going directly to Europe will reach there by way of the less developed countries or via the favored few countries like Canada and Japan, which are accorded access to the New York financial market because they depend upon it for capital and for liquidity. These leaks in the dam will increase as time passes, and the present system of discriminatory controls will become unworkable in the long run. The USA will have to choose between abandoning the whole effort or plugging the leaks. Plugging the leaks, in turn, means that it must either get the countries in whose favor it discriminates to impose their own restrictions or withdraw the preferences it now gives them. Accordingly, the choices in the long run are between no restrictions, restrictions on all outflows, and establishment of what is in effect a dollar bloc, or a dollar-sterling bloc, within which funds move freely but which applies uniform controls against movements to all nonbloc countries.

In the second place, it is not enough to restrain the outflow of US-owned capital. As Germany and Switzerland have found, to keep US funds at home widens the spreads between short-term and long-term rates in Europe and also the spreads between the short-term rates at which European financial intermediaries borrow and lend, and so encourages repatriation of European capital already in the USA. For Europe, this effectively offsets restrictions on capital inflows. 'Home is where they have to take you in.' It would be possible for the USA to block the outflow of foreign capital — possible but contrary to tradition. If this door is left open, the \$57 billion of foreign capital in the USA permit substantial net capital outflows, even without an outflow of US capital. Although it would require powerful forces indeed to induce foreign holders to dispose of most of their American investments, they might dispose of enough to permit the 'deficit' to continue for a long time.

(4) Capital restrictions to correct the deficit, even if feasible, would still leave unanswered a fundamental question. Is it wise to destroy an efficient system of providing internal and external liquidity — the international capital market — and substitute for it one or another contrived device of limited flexibility for creating additions to international reserve assets alone? In the crisis of 1963, Italy borrowed \$1.6 billion in the Euro-dollar

market; under the Bernstein plan it would have had access to less than one-tenth of the incremental created liquidity of say \$1 billion a year, perhaps \$75 million in one year — a derisible amount. It would be the stuff of tragedy for the world's authorities laboriously to obtain agreement on a planned method of providing international reserve assets if that method, through analytical error, unwittingly destroyed an important source of liquid funds for European savers and of loans for European borrowers, and a flexible instrument for the international provision of liquidity. Moreover, agreement on a way of creating additional international reserve assets will not necessarily end the danger that foreigners, under the influence of conventional analysis, will want to convert dollars into gold whenever they see what they consider a 'deficit.'

But, it will be objected, the fears of the European authorities about the dollar are facts of life, and the USA must adjust to them. Several points may be made by way of comment.

Europe squeezes itself

In the first place, the European authorities must be learning how much international trade in financial claims means to their economies, now that it has been reduced. Europe has discovered that liquidity in the form of large international reserves bears no necessary relationship to ability to supply savers with liquid assets or industrial borrowers with long-term funds in countries where financial intermediation is inadequately performed and which are cut off from the world capital market. Financial authorities in Italy, France and even Germany have lately been trying to moderate the high interest rates which reflect strong domestic liquidity preference and the wide margins between the rates at which their intermediaries borrow and lend, as well as (in the case of Germany) their own policies. Having scant success in getting households, banks or private intermediaries to buy long-term securities, these authorities are increasingly entering the market themselves. Investment is declining: in Germany with long-term interest rates touching 8 per cent for the best borrowers, in Italy despite Bank of Italy purchases of industrial securities, and in France where government bonds are issued to provide capital to a limited list of industrial investors. It is ironic that US firms seem able to borrow in Europe more easily than European firms, as they continue investing in Europe while abiding by their government's program of voluntary capital restraint. Given their liquid capital strength in the USA, they have no objection to borrowing short, and command a preferred status when they choose to borrow long. But their operations in Europe put pressure on European long-term rates and enhance the incentive of other European borrowers and US lenders to evade the restrictions.

Europe's own capital markets cannot equal that of the USA in breadth, liquidity and competitiveness in the foreseeable future. Europe must

therefore choose between an open international capital market, using fiscal policy to impose any needed restraints, and use of monetary restraint with an insulated capital market. The second alternative involves serious dangers. Without substantial European government lending to industry, which is unlikely, the terms on which long-term money would be available may cause industrial stagnation.

The first choice is the more constructive one, but it can work only if its implications are understood in both Europe and the USA. The USA, too, has failed to appreciate the role of New York in the world monetary system and has acquiesced in the Continental view of the US payments position. It must be recognized that trading in financial assets with the USA means a US 'deficit'; US capital provides not only goods and services, but liquid assets to Europe, which means European acquisition of dollars. Moreover, the amount of dollars that private savers in Europe will want to acquire for transactions and as a partial offset to debts in dollars, and for other purposes, will increase. This increase in privately held dollars will involve a rising trend in the US deficit on the Department of Commerce definition, though no deficit on the Bernstein Committee definition.

But that is not all. The new liquid saving in Europe which is matched by European borrowing in the USA is not likely to be held largely in dollars, and certainly will not be held entirely so. Savers typically want liquidity in their own currencies, and so do banks. If household and commercial banks want to hold liquid assets at home rather than securities or liquid assets in dollars, the counterpart of foreign borrowing by industry must be held by the central bank of their country in dollars, or converted into gold. This implies a deficit for the USA even on the Bernstein Committee definition.

Whether householders and banks want to hold dollars or their own national currencies, the effect is the same: both alternatives now frighten the USA as well as Europe. They should not. And they would not if it were recognized that financial intermediation implies a decline in the liquidity of the intermediary as much when the intermediation is being performed in another country as when it is being performed domestically. An annual growth in Europe's dollar-holdings averaging, perhaps \$1½ to \$2 billion a year or perhaps more for a long time is normal expansion for a bank the size of the USA with a fast-growing world as its body of customers. To the extent that European capital markets achieve greater breadth, liquidity and competitiveness, the rates of increase in these dollar holdings consistent with given rates of world economic growth would of course be lower than when these markets have their present deficiencies. But whatever rate of growth in these dollar holdings is needed, the point is that they not only provide external liquidity to other countries, but are a necessary counterpart of the intermediation which provides liquidity to Europe's savers and financial institutions. Recognition of this

fact would end central-bank conversions of dollars into gold, the resulting creeping decline of official reserves, and the disruption of capital flows to which it has led.

It must be admitted that free private capital markets are sometimes destabilizing. When they are, the correct response is determined governmental counteraction to support the currency that is under pressure until the crisis has been weathered. Walter Bagehot's dictum of 1870 still stands: In a crisis, discount freely. Owned reserves cannot provide for these eventualities, as IMF experience amply demonstrates. Amounts agreed in advance are almost certain to be too little, and they tip the hand of the authorities to the speculators. The rule is discount freely, and tidy up afterwards, transferring outstanding liabilities to the IMF, the General Arrangements to Borrow, or even into funded government-to-government debts such as were used to wind up the European Payments Union. Owned reserves or readily available discounting privileges on the scale needed to guard against these crises of confidence would be inflationary in periods of calm.

Let the gold go

Mutual recognition of the role of dollar holdings would provide the most desirable solution, but if, nevertheless, Europe unwisely chooses to convert dollars into gold, the USA could restore a reserve-currency system, even without European cooperation in reinterpreting deficits and lifting capital restrictions. The decision would call for cool heads in the USA. The real problem is to build a strong international monetary mechanism resting on credit, with gold occupying, at most, a subordinate position. Because the dollar is in a special position as a world currency, the USA can bring about this change through its own action. Several ways in which it can do so have been proposed, including widening the margin around parity at which it buys and sells gold, reducing the price at which it buys gold, and otherwise depriving gold of its present unlimited convertibility into dollars. The USA would have to allow its gold stock to run down as low as European monetary authorities chose to take it. If they took it all, which is unlikely, the USA would have no alternative but to allow the dollar to depreciate until the capital flow came to a halt, or, much more likely, until the European countries decided to stop the depreciation by holding the dollars they were unwilling to hold before. If this outcome constituted a serious possibility, it seems evident that European countries would cease conversion of dollars into gold well short of the last few billions.

This strategy has been characterized by *The Economist* as the 'new nationalism' in the USA. It can reasonably be interpreted, however, as internationalism. It would enable the USA to preserve the international capital market and thereby protect the rate of world economic growth, even without European cooperation.

While US-European co-operation in maintaining the international capi-

tal market is the preferable route, it requires recognizing that an effective, smoothly functioning international capital market is itself an instrument of world economic growth, not a nuisance which can be disposed of and the function of which can be transferred to new or extended inter-governmental institutions, and it requires abandoning on both sides of the Atlantic the view that a US deficit, whether on the Department of Commerce or the Bernstein Committee definition, is not compatible with equilibrium. Abandonment of this view, in turn, requires facing up to the fact that the economic analysis of the textbooks — derived from the writing and the world of David Hume and modified only by trimmings — is no longer adequate in a world that is increasingly moving (apart from government interferences) toward an integrated capital and money market. In these circumstances the main requirement of international monetary reform is to preserve and improve the efficiency of the private capital market while building protection against its performing in a destabilizing fashion.

The majority view has been gaining strength since 1958, when Triffin first asserted that the dollar and the world were in trouble. Between 1958 and 1965 world output and trade virtually doubled, the US dollar recovered from a slight overvaluation, and the gold hoarders have foregone large earnings and capital gains. Having been wrong in 1958 on the near-term position, the consensus may be more wrong today, when its diagnosis and prognosis are being followed. But this time the generally accepted analysis can lead to a brake on European growth. Its error may be expensive, not only for Europe but for the whole world.

Where we disagree²

Certainly America's deficit represents above all a provision of banking services to other financially less mature countries. Certainly the current attempts to dam up the provision of these banking services threaten constriction for world trade and investment. Certainly one can see no quick replacement for those services, least of all through new official forms of international reserves (from Triffin to Cru). But that was never their intended function. The function of new forms of international credit is not to replace private international lending, but to reinforce it — by warding off the threat of a run on the bank. This is the function of a central bank domestically. Commercial banks have been able to operate as banks and lend long while borrowing short only because of this newly created cash and this ever open rediscount window. Why then can one suppose banking functions can be extended internationally without any such equivalent source of international cash? Britain's own experience in running down its international cash ratio to low fractions provides a warning example that America is bound to heed.

We do not, therefore, see the institution of international credit on an organized basis as merely an optional extra in a working payments system. It is the view that America can, even at this late stage of the day, perform all its old international financing functions without such international support that we have termed 'the new nationalism.' Certainly America should not wed itself inextricably to its present gold buying and selling policy. It may be in the end that jolting the dollar as well as the pound off their present pegs turn out to be the one way in which radical moves to an international monetary order can be launched. What seems unrealistic is to suppose, as our contributors do, that prospects of a possible dollar depreciation will actually uphold the present function of the dollar as a reserve currency by making central banks more willing to hold it. It is this contingent possibility that has surely made them increasingly reluctant about dollar liquidity.

Notes

- 1 For one of many good discussions of the proposals by Triffin, Bernstein and Stamp, as well as others not mentioned above, see *Plans for Reform of the International Monetary System* by Fritz Machlup, Special Paper in International Economics no. 3, revised March 1964 (International Finance Section, Department of Economics, Princeton University). See also Herbert Grubel (ed.), *World Monetary Reform: Plans and Issues* (Stanford, Calif.: Stanford University Press, 1963). For Robert V. Roosa's present views, see his *Monetary Reform for the World Economy* (New York: Harper & Row, for Council on Foreign Relations, 1965). An English translation of the suggestions by M. Valéry Giscard d'Estaing, made when he was Minister of Finance and Economic Affairs of France, may be found in various speeches published under the title *Statements Made by M. Valéry Giscard d'Estaing on International Monetary Problems*, Collection Ouvertures Economiques (Paris: L'Economie, 1965).
- 2 By *The Economist*.

5

An Economist's View of the Eurodollar Market: Two Puzzles

The division of labor between the student of finance and the economist, as implied by the title assigned to this chapter, is, presumably, that the former explicates what the institution is and how it works and the latter says what it all means and how it fits into economic policy. I have had a try at the second task on another occasion.¹ Here I choose to deal with two narrower topics which present puzzling aspects: one concerns institutional functioning; the other, involving policy implications, concerns how the market will behave in untried circumstances. Specifically the questions are:

- (1) How does large-scale transfer of dollars from the Euromarket to the USA take place in a short period of time without trouble?
- (2) Given the large movement from Europe during the last eighteen months in response to tight money in the USA, what will happen to the US balance of payments when interest rates are allowed to fall?

The first of these questions is usefully addressed by reference to the 'crunch' of August 1966 when, according to newspaper accounts, US banks borrowed \$2½ billion in the Eurodollar market in one month. The second question notes the inflow of \$11 billion in Eurodollars between 1 January 1968, and 30 June 1969, with interest rates in the US bill market of 7 per cent or more. The question is whether this accumulated indebtedness makes it impossible to return to the normal range of interest rates when inflation in the USA has been halted for balance-of-payments reasons.

The crunch

As is generally known, the crunch in the USA occurred as a consequence of tight-money policies applied by the Federal Reserve System in the spring of 1966, and reached a peak in July and August 1966 when savings and loan associations, especially in California, had difficulty in meeting with-

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