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The International Position of the U. S. Dollar

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The U.S. dollar as international money

The U.S. dollar plays a unique role in the international economy because it combines the functions of a generally accepted means of international payment with those of a generally held reserve currency.

The pound sterling is also used widely in international payments, but its use as a reserve currency is, on the whole, restricted to the so-called sterling area countries. Gold is used as an international reserve more extensively than dollar and sterling combined, but it is not used as an international means of payment.

At the end of 1960, Governments and central banks held liquid dollar reserves (short-term assets and U.S. Government bonds and notes) of $11.2 billion; sterling reserves of $7.1 billion, of which $5.7 billion was held by sterling area countries; and gold reserves of $38.1 billion, of which $17.5 billion was held by countries other than the two reserve centers (United States and United Kingdom). International bodies, whose resources form an increasingly important secondary reserve for their members, held dollar assets of $4.9 billion, sterling balances of $1.5 billion, and gold reserves of $2.4 billion.

The preponderant importance of the dollar as a means of international payment for both commercial and financial transactions is reflected in the fact that at the end of 1960 foreigners other than Governments and central banks held liquid dollar assets of $7.6 billion and sterling balances of only $3.8 billion, although special circumstances at that time made for abnormally large foreign holdings of sterling.

1/ A German translation of this paper is to be published by the Creditanstalt-Bankverein of Vienna (Austria) on occasion of the Fund and Bank meetings to be held in Vienna in September 1961.

Apart from the dollar funds that represented direct claims on U.S. financial institutions, an estimated $2 billion was held by foreigners, both official and private, in the form of claims denominated in dollars against financial institutions outside the United States (the so-called Euro-dollars). These holdings, far from being a threatening anomaly, are another indication of the pervasive use of dollars in transactions between foreign countries.

The U.S. dollar has become the main international means of payments and reserve currency for two reasons:

It has replaced gold because its supply has been more elastic and has therefore been able to expand fast enough to finance the greatly increased volume of international transactions.

It has replaced sterling because it has maintained full convertibility at stable rates into other currencies and, if held by foreign governments and central banks, also into gold. For the last 25 years, the dollar has been, apart from the Swiss franc, the only major currency that has not been devalued in terms of gold.

These two main roots of the international position of the dollar reveal a dilemma. On the one hand, the dollar must not be so scarce that the international commercial community has to look for more elastic and more readily available means of payment. On the other hand, it must not be so plentiful that the international financial community loses confidence in its convertibility and stability.

The first danger appeared as the so-called dollar shortage in the immediate postwar period. This shortage was successfully eliminated with the aid of an unprecedented program of foreign assistance, extended first to the war-devastated industrialized countries and somewhat later also to the less developed countries of the free world.

The second danger has appeared only recently, when the outflow of dollars seemed to exceed the amounts needed to keep international liquidity at an adequate level. This development has been reflected in a deterioration in the international liquidity of the United States.

The international liquidity of the United States

The international liquid assets of the U.S. economy are defined as the official reserves, consisting almost entirely of gold, plus other short-term claims against foreign countries (as reported by U.S. banks) and drawing rights on the IMF (as measured by the U.S. quota).

The total of these assets has remained remarkably stable in recent years. It amounted to $25.7 billion at the end of 1953, and to $25.5 billion at the end of 1960.

The main change since 1953 has occurred in liquid claims of foreigners against the U.S. economy. These claims are defined as including short-term claims of international institutions, foreign official institutions, and foreign private holders (as reported by U.S. banks), plus international and foreign holdings of U.S. government bonds and notes. Between the end of 1953 and the end of 1960 these claims rose from $12.7 billion to $23.6 billion.

In consequence, the net international liquidity of the U.S. economy (liquid assets minus liquid claims of foreigners) declined from $13.0 billion to $1.9 billion. The great bulk of this deterioration occurred in the years 1958-60 (see Table 1).

Not all foreign assets and liabilities of the United States have the same degree of liquidity. Among the assets, only the official reserves are immediately available to U.S. monetary authorities. Among the liabilities, only those to foreign monetary authorities (Statement of the Secretary of the Treasury, October 4, 1949, and (under special agreements) $800 million of liabilities to the International Monetary Fund, are convertible into gold. On the other hand, under U.S. conditions of full convertibility, not only foreign but also domestic holders of liquid dollar assets may at any time cause their private claims to be transformed into foreign official claims by presenting them for conversion into foreign currencies. U.S. banks (or the Federal Reserve Banks) would have to purchase these currencies abroad, and thus ultimately from foreign central banks, as soon as their own modest holdings of foreign exchange were exhausted.

The drop in net liquidity was closely related to the deficit in the U.S. balance of international payments. 2/ It must be remembered, however, that liquidity is a purely monetary concept; a decline in liquidity does not necessarily imply a deficit in the sense of a decline in wealth. Actually, the international wealth of the U.S. continued to rise throughout the period of the decline in net international liquidity. Total U.S. international assets (including long and short-term investments abroad plus the U.S. gold stock) rose from $61.6 billion at the end of 1953 to $84.3 billion at the end of 1959; while foreign investments in the United States rose only from $23.6 billion at the end of 1953 to $40.7 billion at the end of 1959. The net foreign position of the United States improved therefore in these years by $5.6 billion.

2/ As used in this section, the deficit in the U.S. balance of payments is defined as the decline in the U.S. gold stock plus the increase in liquid dollar claims of foreigners. This concept differs from that of a decline in net international liquidity, apart from technical divergences in a few of the underlying statistical data, only in that an outflow of U.S. short-term capital increases the deficit but does not decrease net liquidity insofar as it adds to short-term claims on foreigners (as reported by U.S. banks). The definition is used because it underlies the conventional presentation of the U.S. balance of payments; for the purpose of economic analysis, it is more useful to define deficit either as the "basic" deficit (as defined below) or as decline in net liquidity (as defined above).

U.S. balance of payments, 1957-61

The U.S. balance of international payments underwent great changes in the period 1957-61 (see Table 2). The current balance (exports minus imports of goods and services, including pensions and remittances but excluding military expenditures) showed its lowest surplus, and the "basic" balance (current surplus minus military expenditures, Government aid and capital payments, and net outflow of private long-term capital) its largest deficit, in the second quarter of 1959. The current surplus rose steadily from then on, mainly because of an increase in exports, but in part also because of a decline in imports, until it approached the average 1957 level in the last quarter of 1960. The "basic" deficit declined correspondingly, except that it was raised somewhat in the last quarter of 1960 by the abnormally large outflow of capital representing the purchase by the Ford Motor Company of minority shareholdings in its British subsidiary.

Movements of volatile funds tended to reduce the deficit in most quarters of 1958 and 1959 but increased it at an accelerating rate in 1960. In consequence of this outflow of volatile funds (including an extraordinary large volume of unrecorded transactions, which appear in the statements as "errors and omissions"), the total deficit reached a peak of $1.4 billion in the last quarter of 1960, although the "basic" deficit had been reduced far below the figures for 1958 and 1959.

In the first half of 1961 "basic" transactions as well as movements of volatile funds were more favorable. The "basic" balance (as defined above) showed a small surplus, and the outflow of funds through unrecorded transactions stopped. In consequence, the over-all deficit was reduced to an annual rate of $1.15 billion. The net international liquidity position of the United States actually improved slightly since the increase in short-term claims on foreigners more than offset the reduction in U.S. gold holdings, while foreign liquid dollar assets declined slightly. In April, the liquidity position was further enhanced by extraordinary repayments of long-term government debts to the U.S. Treasury. Even disregarding these repayments, a tentative estimate of developments in the second quarter permits expectations of continued progress toward equilibrium.

This result may not be good enough, since the cyclical situation (unemployment in the United States and a boom in most other countries) should give the United States a surplus in its international payments and an increase in its net international liquidity large enough to offset any deteriorations bound to occur under contrary cyclical circumstances. Nevertheless, the fact that the United States was able to stop the decline in its net international liquidity during a period of grave uncertainties in foreign-exchange markets may be interpreted as a symptom of the basic soundness of its international economy.

Causes of the decline in U.S. net international liquidity, 1958-60

The decline in net international liquidity which the United States suffered in the years 1958-60 has been attributed to a variety of causes. First and most important was a change in the competitiveness of U.S. export industries. The United States did not, in most sectors, "price itself out of the world market," as was frequently alleged in those years, but many of its competitors, especially in continental Europe, priced themselves into it.

Some U.S. industries indeed raised prices more than their foreign competitors. In general, however, exports suffered most from lack of interest and from unwillingness to adapt products to the needs of foreign markets: in the words of an eminent business leader, A. K. Watson, business tended "to threat the foreign market as a place to unload surplus production" (speech before Investment Bankers Forum, Washington, D.C., May 8, 1961).

This attitude may have reflected a slack in U.S. activities, which was not confined to the economy: the late 'fifties also witnessed a relative decline in U.S. military and political power and a falling behind in some fields of science and technology. It took the shock of serious reverses, including the threat to the international standing of the dollar, to dispell this satiated sleepiness. The deterioration and subsequent improvement in the international liquidity of the United States may thus be interpreted as part of a pervasive cycle in its social, cultural, and economic life.

This general cause was reinforced by more specific factors. One of them was the behavior of two major U.S. industries. The failure of the automobile industry to conform to consumer wishes led to a sharp rise in imports of foreign cars until the advent of U.S.-made "compact" cars began to redress the balance. The practice of the steel industry of raising prices in times of falling as well as of rising demand has been regarded as the largest single cause of the increase in the level of U.S. industrial export prices; coupled with the disruptive battle between management and labor that occurred in this industry in 1959, it worked to transform temporarily the United States from a steel-exporting to a steel-importing country.

A second but in my opinion more doubtful factor was the alleged "wage-push" inflation in the United States. Although "wage-push" has been accepted as an explanation of the rise in U.S. prices by the eminent authors of the recent OEEC report on inflation, I do not find that hypothesis consistent with the facts. The only well-organized members of the U.S. labor force in manufacturing industries are the production workers. Payrolls of these workers have not risen faster than production: between 1953 and 1960, output of U.S. manufacturing industries increased 17 per cent while payrolls of production workers increased only 12-1/2 per cent. The rise in wages of organized labor cannot, therefore, be held responsible for the price increases of that period (8-1/2 per cent on the wholesale and 11 per cent on the consumer level) -- although it may well have contributed to the constant decline in the number of production workers in industry.

A third explanation is based on the allegedly excessive international commitments of the United States. These commitments, including foreign aid and military expenditures abroad, indeed impose on the United States an outlay of $6 billion annually. From the point of view of the U.S. balance of payments, however, a difference should be made between foreign aid and military expenditures. The bulk of foreign-aid expenditures is used for procurement in the United States, which does not involve a net burden on the economy in general or the balance of payments in particular, as long as there are ample idle resources available.

In contrast, military expenditures in countries that use their receipts for accumulating reserves rather than for increasing their imports from the United States, impair <u>pro-tanto</u> the liquidity position of the United States. The U.S. deficit would have been reduced to more manageable proportions if other countries (e.g., Germany) had assumed a more equitable share of the military expenditures needed to defend the free world.

This consideration leads to a fourth factor, the impact upon the United States of the persistent surplus in Germany's international payments, which the German authorities themselves have recognized as a threat to international financial equilibrium. This surplus has affected the United States not only on current but also on capital account, by contributing to the flows of volatile capital from the United States to Germany in the expectation of appreciation profits. Since the market apparently was not satisfied that the appreciation of the German mark in March 1961 would in itself suffice to eliminate Germany's surplus, this outflow has not yet stopped, although it seems to have passed its peak.

Appropriate corrective actions

Equilibrium in the balance of payments of the United States, as of any other country in a similar situation, requires a surplus on current account (exports minus imports of goods and services) large enough to cover the outflow of long-term funds for private investment and government commitments abroad, and movements of volatile funds in excess of the moderate and reversible flows that usually accompany cyclical fluctuations. Correction of disequilibrium involves, therefore, efforts to increase the current surplus, to reduce the outflow of long-term funds, and to keep movement of volatile funds within manageable proportions.

Current account -- The current-account surplus of the United States has reached a level nearly equal to the record figure of 1957. The main problem in this respect is, therefore, not so much to increase this surplus as to prevent it from declining. This means that the United States must continue its endeavors to keep price and wage movements under control in the course of the current recovery from the 1960 recession.

While there are some differences of opinion about the best ways to achieve this purpose, and especially about the correct "mix" of fiscal policy, monetary policy, and "moral suasion," the goal itself is not in dispute. Recent developments have proved that the United States can no more than any other nation conduct its internal affairs without regard to its balance of payments. The effects of a deterioration in the international financial position on the status of the United States as the economic and political leader of the free world have persuaded all shades of public opinion that avoidance of such a deterioration, and therefore of inflation, is a prime requisite of U.S. policy.

In the international field, the main U.S. effort to avoid a deterioration in its current account must be concerned with the tendency toward regional preferences which involve discrimination against imports from the United States. The political benefits of closer cooperation among European nations have induced the U.S. Government to approve European regionalism in spite of its effects on the U.S. balance of payments. This does not mean, however, that these effects can be completely overlooked.

A regional organization that keeps discrimination at a minimum may actually benefit international trade because the uplift in the regional economy may, in the long run, more than offset discriminatory trade barriers. An organization that aims at autarky could restrict international trade so much that it would hurt the economic welfare of the region itself together with that of its former trading partners. The hazard of excessive discrimination is particularly grave in the agricultural sector, in which the United States enjoys very high efficiency, whereas some European countries tend to be the more protectionist, the more inefficient their own production.

Capital accounts -- The outflow of long-term capital from private as well as Government sources to less developed areas is so important for the healthy expansion of the world economy that a contraction of this flow seems undesirable. In contrast, large U.S. investments in continental Europe, often based on tax and tariff advantages, do not always seem to serve the needs of either side. The U.S. Government has proposed to avoid excessive outflows of that kind by removing tax incentives for investment in fully developed countries, and these efforts need to be supplemented by actions of the European countries aimed at avoiding artificial stimulation of a capital inflow.

The most disturbing factor since mid-1960 has been the behavior of volatile capital. Insofar as flows of such capital are due merely to interest-rate differentials, their influence is limited; these differentials tend to be reversed in the course of cyclical fluctuations, and their effect tends to be offset by movements of forward exchange premia and discounts. The flows mainly become dangerous if they reflect lack of confidence in the maintenance of existing exchange rate patterns. Such flows can be stopped for good only by actions restoring international confidence. In the short run, their effect on the reserve positions of the countries involved can be neutralized by the cooperation of central banks and by actions of the International Monetary Fund.

International monetary cooperation -- Central bank cooperation has been initiated with apparent success by the members of the Bank for International Settlements on occasion of the outflow of funds from the United Kingdom following the German revaluation. Methods to improve the mechanism of cooperation are under discussion in a working group of the Organization for European Economic Cooperation, which is in the process of being transformed into the Organization for Economic Cooperation and Development.

The chances of successful action of the International Monetary Fund will be enhanced if the Fund is permitted to increase its resources by borrowing from those countries to which volatile capital is flowing. It is to be hoped that a program of this kind will be presented to the Fund's Annual Meeting.

Under modern conditions, government policies aimed at restoring international equilibrium are hampered on two counts: in deficit countries, contractive policies are severely limited by the risk that depression or stagnation may be precipitated; in surplus countries, expansionary policies are limited by the possibility of reinforcing inflationary pressures. In view of these limitations, it is difficult if not impossible for either group of countries to restore equilibrium if the major countries of the other group refuse to participate in the effort.

In particular, "a sustained accumulation of gold and other international reserves by any one country is disruptive to the international community" (Aide Memoire of the U.S. Department of State, February 20, 1961). Cooperation among monetary authorities, and governments in general, can therefore not be restricted to the specific measures needed to avoid or neutralize excessive movements of volatile funds but must extend to the question of basic policies.

British and German corrective actions -- At present, restoration of confidence in the maintenance of existing exchange-rate patterns hinges mainly on the prospects of correcting the excessive surpluses and deficits of two major countries, the surplus of Germany and the deficit of the United Kingdom.

This is not the place to discuss the policies that are in the interest of these countries. Suffice it to point out that the foreign trade balance of the United Kingdom has shown considerable flexibility in recent years; this flexibility may justify the expectation that relatively slight reduction in domestic monetary demand would free enough factors of production to permit both an increase in exports and a reduction in imports and thus to bring the country's international accounts into equilibrium.

At the same time, the high level of employment in the United Kingdom may justify the expectation that such shifts would occur without serious hardship.

In Germany, the long-term influences of the mark revaluation on German exports and imports have not yet had time to become apparent. Moreover, it is to be hoped that further acceleration in the modest expansion of domestic demand, together with the elimination of tax incentives for exports and tax burdens on imports, the assumption of a more equitable share in military expenditures, and an increase in the outflow of long-term capital (including foreign aid), would suffice to absorb the remaining export surplus.

Inappropriate actions

The international role of the dollar poses problems for U. S. international monetary policy that most other countries do not have to face. The United States, in defending the stability of the dollar, has to defend not just its domestic currency but the main currency of the free world. This means not only that its responsibility is heavier, but also that it cannot use some policy measures that are available to other countries. For instance, it cannot use the safety valves of currency devaluation or exchange restrictions, either of which would greatly impair if not completely destroy the international usefulness of the dollar.

Fortunately, the strong position of the current balance of the United States makes it unnecessary to consider even academically the question of a need for such measures.

There is also no reason to believe that the reserve currency standard need be abandoned for the sake of restoring and maintaining international equilibrium. Such a step has been recommended in recent years by two schools of critics of the present system.

Return to the gold standard -- One school advocates an increase in the price of gold as a preliminary condition of a return to the so-called classical gold standard. This idea could evolve only in the minds of economists who have forgotten (or never learned) the lessons of the Great Depression. No country today is prepared to forego counter-cyclical action and thus to risk another breakdown of the economy of the free world, merely in order to stop an outflow of gold.

While some countries have created difficulties for themselves and others by disregarding the effects of their counter-cyclical or developmental policies on the balance of international payments, such mistakes can be avoided without forcing the world economy back into a straight jacket. Moreover, the straight-jacket therapy does not work in practice; whenever the patient needs restraint most urgently, he manages to discard it. The reintroduction of the gold standard after the first world war did not prevent the world from engaging in the reckless financial transactions of the 'twenties which led to the breakdown of the international payments system in the 'thirties.

This argument is reinforced by the consideration that an increase in the price of gold -- which even the most dogmatic adherent of the gold standard regards as an indispensable prerequisite for a return to that standard -- would benefit the largest producers and holders of gold, who are least in need of such benefits; and might have serious deflationary effects on the other nations, who would lose confidence in the stable value of their foreign-exchange reserves and hasten to convert them into gold.

Establishment of international super-central bank -- More serious than the recommendation of a return to the gold standard is the program of the other school, which advocates the transformation of the International Monetary Fund into an international super-central bank. This is not the place to discuss this proposal in detail. Suffice it to say that, under the reserve currency standard, the free world has enjoyed since the end of the second world war, an unprecedented increase both in domestic production and in foreign trade; thus the need for an abolition of that standard is, to say the least, not obvious.

Furthermore, the advocates of such a transformation overlook the fact that the international use of means of payments is based on the confidence of the economic community rather than on the dictates of some government agency. Within any country, the sovereign may attribute legal tender quality to any means of payment he chooses, and may thus enforce the acceptability of the domestic currency, unless it is so completely mismanaged that the money economy itself breaks down. Internationally, however, banks, business men, and investors will accept means of payments only if they have confidence in its convertibility, at stable rates, into the national currencies they need. There is no reason to assume that they would have greater confidence in tokens created by some international institution than in the currencies issued by the well-managed central banks of the leading countries.

An international body, inevitably dominated by the monetary authorities of the leading countries, would hardly be considered better managed and worthy of more confidence than the central banks of these countries themselves. The assets of such a body, which at best would consist of claims on well-managed countries but which more likely, for obvious political reasons, would also include large claims on ill-managed countries, could hardly be considered safer and more worthy of confidence than the assets of the central banks of the well-managed countries.

The basic arguments are reinforced by the difficulties that would be created by potential or actual conflicts between the monetary policies of the super-central bank and the national central banks. These conflicts could be avoided or solved only if one of two alternatives were adopted. Either the super-central bank would be subordinate to the policies of the national central banks; in this case the situation would be basically the same as under the present system. Or the national central banks would be subordinate to the policies of the super-central bank (just as in the United States the individual Federal Reserve Banks have to execute the policies of their central institutions, the Board of Governors and the Federal Open-Market Committee); in this case the super-central bank would acquire paramount power over the monetary policy, and thus largely over the entire economic policy, of the member countries. To expect such a transfer of power would be no less unrealistic than to expect a return to the gold standard.

Problem of domestic adjustments -- Neither a return to the gold standard nor the creation of a super-central bank would solve the main problem that is confronting the international payments system at present. This problem is the inability or unwillingness of some countries to make the domestic adjustments that would put their basic balance of international payments in order. It is the lack of these adjustments that creates excessive and persistent deficits or surpluses; impairs confidence in the maintenance of existing exchange-rate and convertibility patterns; and gives rise to excessive flows of volatile capital, which in turn add to those deficits and surpluses and thus create a vicious circle. It is idle to suppose that countries which resist the gentle restraint of the present reserve currency standard on their domestic policies would willingly submit to the harsher restraints of the gold standard or of the decisions of an international super-central bank.

It is true that the leading countries could wreck the reserve currency standard by following policies inconsistent with international financial equilibrium; just as, by doing so, they would wreck the gold standard or a standard administered by a super-central bank. If they abstain from irresponsible policies, the reserve currency standard can be maintained and the trauma of undoing the present mechanism of international payments need not be inflicted on the world economy. If they insist on following such policies, the present standard may have to be abandoned, but so would any other rational mechanism of international payments.

Fluctuating exchange rates -- For the same reasons, the more modest proposal to reduce the danger of persistent international disequilibrium by permitting wider exchange margins and gold points for all currencies, including reserve currencies, or by abolishing fixed par values altogether, is unlikely to achieve its purpose. If the major countries refuse to follow stabilizing policies, flexible exchange rates cannot restore equilibrium; if they follow such policies, flexible exchange rates are unnecessary. Adjustments in the exchange rates of countries other than those with reserve currencies may sometimes be advisable or necessary; but abolition of the par values of the international reserve currencies would destroy the usefulness of foreign-exchange reserves as completely as an increase in the price of gold -- with the difference that it would not confer any benefit on the countries holding large gold reserves.

The future role of gold and the dollar

For some strange reason, economists have not been endowed with the gift of prophecy. If the greatest economic genius had tried, in 1911, to foresee the international economic problems of 1961 and to propose institutional arrangements for solving these problems, only the most unlikely coincidence would have prevented such an enterprise from turning into complete nonsense. Any attempt of an economist in 1961 to foretell the problems of the next 50 years, and to recommend institutional changes to deal with those problems, would hardly escape a similar fate.

At most, we may try to evaluate the problems most likely to confront us in the immediate future, under the assumption that there would be no fundamental change in the political, technological, and economic conditions and relations of the free world. Under this assumption, it seems likely that gold and the dollar would also continue to play their role in international payments without major change.

Arguments against reserve currency standard -- Some eminent economists contend that the reserve currency standard would be doomed, at least in the long run, because the supply of gold and of reserve currencies could not continue to rise fast enough to satisfy the liquidity needs of a continuously expanding world economy. The argument has sometimes been confused by questionable statistics; using the best data available, it may be given the following formulation.

Between 1953 and 1960, world trade (exports plus imports) rose from $152 billion to $232 billion; the average annual rate of increase was thus 6 per cent. In 1960, world reserve liquidity (as measured by monetary gold held by governments and central banks, plus official and private foreign holdings of liquid dollar and sterling assets, and unused quotas of the International Monetary Fund) was around $80 billion.

If we assume (as we optimistically should) that world trade would continue to expand at a similar rate, and also assume (as we should not) that world liquidity would have to rise in the same proportion in order to avoid a liquidity crisis, the necessary increase in liquidity would be around $4.8 billion annually. Gold production in the free world amounted to $1.2 billion in 1960; although the supply of gold is supplemented by Soviet sales, the demand for industrial uses and for private hoarding must be expected to reduce availabilities for monetary purposes to, say, \$0.8 billion annually. Other liquid assets would thus have to rise each year by \$4 billion.

Foreign holdings of dollars and sterling are increased only if the United States and the United Kingdom have deficits in their international payments. A combined annual deficit of \$4 billion, no matter how distributed among the two countries, would soon undermine confidence in the reserve currencies. Increases in Fund resources of such magnitude may be voted once every ten or fifteen years, but not year by year. The reserve currency system would,therefore, inevitably be destroyed before long by a steady deterioration either in the world liquidity position or in the international standing of the reserve currencies.

Future role of gold -- This reasoning discloses some genuine problems. It is true that, under any reasonable estimate, prospective world liquidity needs cannot be expected to be satisfied by the prospective rise in supplies of monetary gold. This precludes gold from playing a more prominent role in international payments than at present. On the other hand, gold is also unlikely to be relegated to a less prominent role.

Gold is distinguished from national currencies in that its supply is basically independent of government action. The distrust of government intervention, which long experience has implanted in the heart of bankers, may well be a main explanation for the traditional propensity of central banks to hold at least part of their reserves in an asset that they believe to be less vulnerable to government manipulation than any available alternative. Actually, gold offers no protection against Government mismanagement. governments can not only dispossess the national central banks (and have done so regularly), but they can also decrease as well as increase the value of gold in terms of the national currency. The recent appreciation of the German mark and the Netherlands guilder in terms of gold has shown that national currencies may be not only as good as gold but sometimes even better.

In spite of this experience, the gold tradition is too deeply rooted to be overthrown. In fact, it may become easier for central banks to get hold of additional gold, since the experience may have reduced private demand for gold hoarding. Nevertheless, the ratio of gold to reserve currencies and Fund quotas is more likely to decline than to rise. Central banks, however, know that, whatever this ratio, they cannot hope simultaneously to convert all their reserve currency holdings into gold: if they tried to do so, they would wreck not only the reserve currency standard but also any other international payments mechanism that is not based on 100 per cent gold reserves. Assuming reasonably rational behavior on the part of central banks and governments, the reserve currency standard can therefore be expected to weather without difficulty the prospects of a steady moderate decline in the gold reserve ratio.

Measurement of liquidity needs -- The decisive question is thus whether the supply of reserve currencies can be further increased without undermining confidence in their convertibility and stability. If it were true that a very large continuous increase would be needed, or that the increase could be accomplished only through continuous deficits in the international payments of the reserve currency countries, the outlook would be bleak indeed. Fortunately, neither of these statements is likely to prove correct.

During the period 1953-60, when world trade increased at an average annual rate of 6 per cent, world reserve liquidity (defined as before) rose from $63 billion to $81 billion, or at an average annual rate of little more than 3 per cent (Table 3). It is true that the increase was greater for the world outside the United States; for that area the average annual increase in international trade was nearly 7 per cent and in liquidity 5 per cent. In 1953, however, the countries other than the United States bitterly complained of illiquidity, the so-called dollar shortage, while in 1960 the large movements of volatile capital were symptoms of excessive liquidity. Moreover, in 1953 liquidty was augmented for the European countries and their overseas monetary areas by the facilities of the European Payments Union, which came to an end in 1958.

Domestic experience confirms the validity of the assumption that liquidity need not rise as fast as economic activity. In the United States, the supply of primary liquidity (currency and demand deposits) rose 10 per cent from 1953 to 1960, while gross national product rose 38 per cent. The point is not whether output might have risen even faster if the money supply has expanded more rapidly; but that the actual increase in primary liquidity supported, without any difficulty, an increase in income nearly four times as large.

It would be futile to engage in elaborate computations trying to show the optimum relation between rise in liquidity and trade expansion. Suffice it to say that world liquidity certainly need not rise as fast as world trade, perhaps as little as one-fourth and probably not more than one-half as fast. Under the most optimistic assumption, the required rise in non-gold reserves would be so small that it could consist exclusively of periodic increases in Fund resources. Under the most pessimistic assumption, a steady moderate rise in foreign holdings of dollars or sterling would remain essential.

Liquidity creation without payments deficit -- Such a rise could conceivably be accomplished without a deficit in the international payments of the reserve currency countries. Although the argument that equates an increase in foreign holdings with such a deficit has never been challenged, it is based on a misconception of money creation. 3/ In a modern economy, domestic means of payments consist exclusively of claims against the central bank (cash) and claims against commercial banks (deposits). Nevertheless, nobody believes that domestic means of payments can be increased only if the central bank and the commercial banks continuously run deficits. Actually, these means of payments are increased by the banks exchanging short-term claims on their customers against their customers' claims on themselves.

Internationally, means of payments can, and should, be created in the same way. During most of the 19th century, the leading London financial institutions created liquidity by granting credits to foreigners and accepting foreign bills of exchange. These actions did not represent continuous deficits in the international payments of the United Kingdom; on the contrary, they made the United Kingdom the strongest financial power of the world.

Similarly, between December 1953 and December 1960, the financial institutions of the United States acquired short-term claims against foreigners totaling $2.7 billion and in turn increased their liabilities to foreign private customers by $2.7 billion. The creation of these liabilities increased the international liquidity of the rest of the world without inflicting a deficit on the United States or reducing its net international liquidity.

3/ In this section deficit is defined as meaning "basic" deficit (see footnote 2, above). If "deficit" is explicitly defined so as to include (in addition to changes in the gold stock) any increase in foreign holdings of the domestic currency, the statement that such an increase must always raise the deficit is a tautology devoid of economic meaning.

There is no reason for this process to stop. In fact, it has recently been supplemented by a similar behavior of the U.S. monetary authorities. For the first time since the 'thirties, the U.S. monetary authorities have acquired official holdings of foreign convertible currencies; in other words, they have exchanged short-term claims on foreign monetary authorities for short-term liabilities to these authorities. These transactions have increased the gross liquidity of all parties involved, without creating a deficit or reducing net liquidity for any of them. Similar transactions will take place when the IMF receives permission to "borrow" from its member countries, i.e., exchange short-term claims on its members for short-term claims on itself.

Creation of mutual liquid claims through the cooperation of central banks as well as by private financial institutions, reinforced by additions to monetary gold, the proposed credit operations of the Fund, and if need be also by periodic general increases in Fund resources, can amply provide for any increase in international liquidity needed in the foreseeable future. Actually, credits are the most economic way of creating liquidity: they provide liquidity to those countries that need it (e.g., the less developed areas or countries suffering from sudden strains in their current or capital accounts) rather than indiscriminately to the needy and the greedy.

<u>Prospects of U.S. payments equilibrium</u> -- Nevertheless, the international dollar standard would still be doomed if restoration and maintenance of equilibrium in the international payments of the United States could not reasonably be expected in the foreseeable future. Actually, however, these prospects are pretty good, provided that the United States continue to pursue responsible fiscal and monetary policies.

Domestically, the brief and mild recession of 1960 -- the briefest and mildest of postwar experience -- appears to have been overcome so that radical expansionary policies seem no longer either necessary or likely. Internationally, the large surplus on trade account may not continue for long since recovery in the United States will mean a rise in imports, and the eventual levelling out of the boom in Europe will mean a levelling off, and perhaps a decline, in exports. On long-term capital account, however, prosperity in the United States may be expected to reduce the net outflow of investment funds, and this reduction may well be large enough to offset the greater part of the deterioration on current account.

Similarly, the flows of volatile payments may be expected to stop, or even to be reversed, as soon as the financial community is persuaded that no significant changes in exchange-rate patterns need be feared (or hoped for). Even the interest-rate differential between the United States and Europe, whatever its influence on short-term capital movements, should move in favor of the United States as soon as the cyclical situation changes toward more rapid expansion, and therefore higher equity yields and interest rates, in the United States, and less rapid expansion, and therefore lower yields and rates, in Europe and Japan.

Conclusion

The question is sometimes asked whether it is worth while for the United States to maintain the position of the dollar as an international reserve currency, since the direct advantages which this status gives to the U.S. economy may well be smaller than the disadvantages resulting from the constraint which it imposes on U.S. policies.

This question is moot. The dollar has emerged as a reserve currency not by design, not by actions of the U.S. Government or the U.S. business community. It has replaced gold and sterling because of the confidence it has inspired among the other nations of the world. It will retain its status as long as this confidence is maintained, and will lose it if this confidence should be lost. The effect of such a loss on world trade and finance, and probably on the political coherence of the free world as well, would be even more disastrous than was the loss of confidence in sterling during the great depression.

The importance of the reserve currency status of the dollar for the international economy, rather than its importance for the United States, makes it imperative to maintain that confidence. The chief responsibility for the necessary policies rests, needless to say, on the United States; but other countries can also do much to assure success or invite failure. For this reason, the present efforts to achieve closer monetary cooperation between the United States, the other free nations, and our common institution, the International Monetary Fund, may decide the future of the international payments mechanism, and thus the economic development of the free world.

Table 1

International Liquidity of United States, 1953-61

(Millions of dollars;
end of month figures)

	1953 (Dec.)	1957 (Dec.)	1958 (Dec.)	1959 (Dec.)	1960 (Dec.)	1961 (Mar.)
Assets:						
U.S. gold stock	22,091	22,857	20,582	19,507	17,804	17,433
Short-term claims 1/	905	2,199	2,542	2,623	3,590	3,980
IMF quota	2,750	2,750	2,750	4,125	4,125	4,125
Total	25,746	27,806	25,874	26,255	25,519	25,538
Liabilities:						
Short-term claims 1/ of:						
International institutions	1,629	1,517	1,544	3,158	3,954	3,872
Foreign official holders	5,667	7,917	8,665	9,149	10,320	10,300
Foreign private holders	4,352	5,724	5,950	7,076	7,046	6,910
U.S. Government bonds and notes	1,091	1,442	1,478	2,167	2,326	2,523
Total	12,739	16,600	17,637	21,550	23,646	23,605
Balance	13,007	11,206	8,237	4,705	1,873	1,933

1/ As reported by U.S. banks.

Source: (Except for IMF quota): Federal Reserve Bulletin

Table 2

U. S. Balance of Payments, 1957-61

(Millions of dollars; quarterly figures)

	1957	1958	1959 1st qtr.	1959 2nd qtr.	1959 3rd qtr.	1959 4th qtr.	1960 1st qtr.	1960 2nd qtr.	1960 3rd qtr.	1960 4th qtr.	1961 1st qtr.
	(Quarterly rates)		(Seasonally adjusted)								
Exports: Merchandise 1/	4,848	4,066	3,866	3,924	4,299	4,193	4,650	4,837	4,927	4,995	5,044
Services	1,835	1,765	1,819	1,793	1,856	1,959	1,915	1,991	1,927	2,058	2,051
Imports: Merchandise	-3,323	-3,238	-3,601	-3,861	-3,974	-3,858	-3,785	-3,830	-3,674	-3,433	-3,361
Services 2/	-1,117	-1,172	-1,222	-1,272	-1,303	-1,337	-1,373	-1,438	-1,402	-1,344	-1,358
Pensions & remittances	- 175	- 180	- 184	- 187	- 214	- 206	- 198	- 213	- 207	- 230	- 210
Current balance 1/2/	+2,068	+1,241	+ 678	+ 397	+ 664	+ 751	+1,209	+1,347	+1,571	+2,046	+2,166
Military expenditures 1/	- 791	- 853	- 780	- 789	- 786	- 754	- 767	- 756	- 798	- 727	- 759
Government aid & capital (net) 1/	- 644	- 647	- 486	- 583	- 587	- 330	- 582	- 695	- 605	- 868	- 887
Private long-term capital (net)	- 639	- 628	- 470	- 432	- 367	- 474	- 351	- 377	- 528	- 991	- 354
"Basic" balance	- 6	- 887	-1,058	-1,407	-1,076	- 807	- 491	- 481	- 360	- 540	+ 166
U. S. short-term capital	- 64	- 77	+ 89	+ 3	- 11	- 158	- 156	- 83	- 534	- 539	- 507
Errors and omissions	+ 187	+ 95	+ 84	+ 276	- 103	+ 271	+ 33	- 142	- 212	- 327	+ 53
Total balance	+ 117	- 869	- 885	-1,128	-1,190	- 694	- 614	- 706	-1,106	-1,406	- 288

1/ Excluding military transfers under grants.
2/ Excluding military expenditures.

Source: U. S. Department of Commerce.

Table 3

World Liquidity and World Trade, 1953-61

(Billions of dollars;
end of month figures)

	1953 (Dec.)	1957 (Dec.)	1958 (Dec.)	1959 (Dec.)	1960 (Dec.)	1961 (Mar.)
Monetary gold 1/	34.6	37.6	38.2	37.8	38.1	38.2
Foreign liquid dollar assets 1/	10.8	14.9	15.6	17.7	18.8	18.7
Foreign sterling balances 1/	9.8	9.2	9.4	9.8	10.9	10.4
Unused IMF quotas	7.5	7.3	7.5	12.7	13.9	13.9
Total	62.7	69.0	70.7	78.0	81.7	81.2
World trade 2/	151.6	209.1	197.2	208.3	231.8	3/ 233.0

1/ Excluding holdings of international institutions.

2/ Sum of annual exports (f.o.b.) and imports (c.i.f.).

3/ Estimated annual rate of first quarter.

Sources: Monetary gold and dollar assets: Federal Reserve Bulletin
Sterling balances: Bank of England, Quarterly Bulletin
IMF quotas and World Trade: International Monetary Fund, International Financial Statistics.