ESSAYS IN INTERNATIONAL FINANCE

No. 116, May 1976

WORLD AFLOAT: NATIONAL POLICIES RULING THE WAVES

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This is the one hundred and sixteenth number in the series ESSAYS IN INTERNATIONAL FINANCE, *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

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Library of Congress Cataloging in Publication Data

Brown, Weir Messick, 1914-
World afloat, national policies ruling the waves.

(Essays in international finance ; no. 116 ISSN 0071-124X)
1. International finance. 2. Monetary policy. 3. Foreign exchange problem. I. Title. II. Series: Princeton University. International Finance Section. Essays in international finance ; no. 116.
HG136.P7 no. 116 [HG3881] [332.4'5] 76-9833

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

World Afloat: National Policies Ruling the Waves

Introduction

Since March 1973, the world's trade and payments have been conducted under an international monetary regime that differs in important respects from the system envisaged in 1944 at Bretton Woods and the one largely followed in succeeding years. Furthermore, the current regime does not fully correspond to the conceptions of any of the major protagonists in the running (sometimes walking) dialogue about the proper image of a "reformed" monetary system, nor has it been fully codified in any internationally agreed form of accord.

The aim of this essay is to examine one major area or aspect of the *de facto* international monetary system: the role currently being played by official monetary reserves and the practices adopted by national authorities in the industrial countries to manage their external monetary policies in a world of fluctuating rather than fixed exchange rates. The primary object of the examination is to characterize the existing situation with respect to these matters rather than to ask what it should or will be.

Most observers of the present monetary scene focus their attention principally on fluctuating exchange rates themselves, and these are certainly the most highly visible feature of the current arrangements. The movements of individual exchange rates have been extensively measured, both bilaterally and in trade-weighted indexes, and the behavior of the foreign-exchange markets since the first quarter of 1973 has been compared with that of the immediately preceding years. A preponderant majority of the recent assessments is favorable toward the experience with floating rates. Even the *Annual Report* of the International Monetary Fund (1975) reflects the majority view in stating, "On the whole, exchange rate flexibility appears to have enabled the world economy to surmount a succession of disturbing events, and to accommodate divergent trends in costs and prices in national economies with less disruption

The period under review in this essay is limited mainly to the span from early 1973 to November 1975.

The author thanks those who assisted him with information or advice at various stages, notably Raymond Bertrand, Charles A. Cooper, J.C.R. Dow, Otmar Emminger, Lawrence B. Krause, J. R. Lademann, Walter S. Salant, and Thomas D. Willett.

of trade and payments than a system of par values would have been able to do" (p. 33).

The use of official reserves and other instruments of external monetary policy—an aspect of the present system that has received relatively little attention—has shown fewer changes than had been expected in consequence of the shift to fluctuating exchange rates. This appearance of general continuity applies to the evolution of the aggregate reserve holdings for all countries combined. In the course of 1974, aggregate official reserves rose by $36 billion, a growth rate of almost 20 per cent, and in the first half of 1975 they grew at an annual rate of about 9 per cent. These rates of increase correspond generally to those prevailing in the previous five years.

In addition, the composition of the total reserve stock remained unaltered during the past two years. About 90 per cent of the increase in official reserve assets has taken the form of foreign-currency holdings, and the remaining tenth results from larger reserve positions in the IMF. Total country reserves of gold and SDRs were virtually unchanged.

Aggregate official reserves did show a change, however, in geographical distribution or, more exactly, in distribution among types of country. The major oil-exporting countries as a group garnered seven-eighths of the total addition to aggregate reserves in 1974. Although some expansion in the holdings of the oil-exporting countries had already begun in the immediately preceding years, the 1974-75 jump, while not equaling the full amount of their balance-of-payments surpluses, was dramatic.

Before moving on to comment on the external monetary policies of the leading governmental authorities, we can profitably draw some observations from the data on the global aggregates. The period covered by the present *de facto* international monetary regime, especially the interval between the end of 1973 and mid-1975, has witnessed a substantial growth in the total stock of official reserves, of an order comparable to reserve accumulation in preceding years. This occurred despite the fact that economic activity in most industrial countries was stagnant or declining during 1974-75, in contrast to the generally expansionary trend of the preceding years. The period was also characterized by radical shifts in balance-of-payments positions on current account, involving in the main an enormous disequilibrating shift in current-account payments from oil-importing countries, developed and developing, to oil-exporting countries.

Reserve holdings of the industrial countries as a group had been growing in 1970-72 at a pace sufficient to keep ahead of the rise in world prices. From the end of 1972 to the end of 1974, however, the real value of re-

serves (using an index of the industrial countries' export prices as a deflator) fell by about 23 per cent. One should not place too much reliance on reserve figures expressed in constant prices, owing to the formidable technical and conceptual obstacles to such a construction, especially when computed from series as highly aggregated as those for industrial countries as a group. Yet some notion of real reserves should be borne in mind in times of rapidly changing prices and balance-of-payments relations.

To repeat, almost all the net increase (in current prices) of world stocks of reserves was registered by the oil-exporting countries in 1974, and these countries accumulated almost $33 billion without causing a reduction in the reserves of the rest of the world. These two facts have been noted in financial circles, sometimes in terms that betray a certain mingling of guarded satisfaction or relief (that other countries' reserves were not depleted), of mystified admiration that the system was able in some quasi-automatic manner to produce the balance-of-payments financing required, and of anxiety that the system might not duplicate that performance again and that, were it to do so under expansionary conditions, the growth in official liquidity might not, in contrast to 1974, be relatively noninflationary (see Deutsche Bundesbank, 1975b, pp. 53-54, and IMF, 1975, pp. 38-39).

The "anxious" ingredient in these mixed feelings has led recently to demands for implementation of the Committee of Twenty proposal for more active multilateral surveillance of international liquidity. It is not clear whether those who call for greater cooperative control of liquidity creation view the 1974-75 experience as a repetition of the process made familiar in 1965-72, whereby the accumulation of dollar assets by foreign monetary authorities reflected directly the financing of U.S. payments deficits, or whether they perceive the presence of an additional process in 1974-75. The $36 billion increase in global monetary reserves during 1974, although mainly in the form of foreign-exchange holdings, including dollars, was not the approximate counterpart of the U.S. balance-of-payments position. In earlier years, by contrast, official reserve transactions associated with U.S. deficits accounted for a very high proportion of the increase in other countries' official holdings of foreign exchange (all currencies).

During 1974, the U.S. balance on goods and services (apart from oil) moved, with some fluctuations, toward equilibrium. In 1975 the current account strengthened much further and the basic balance began to show a surplus also. Thus, while the currency reserves of all countries increased by $31.5 billion in 1974, an amount almost equal to the rise in 1971, only

26 per cent of this growth resulted from U.S. reserve transactions, as compared with more than 80 per cent in both 1970 and 1971. These strange results are explained in large part by the monetary policies followed by some of the major industrial nations, as will be demonstrated below.

The situation of the typical oil-importing industrial country during 1974-75 was characterized in the monetary field by a significant deficit (or sharply decreased surplus) in its international balance on current account and by sharp fluctuations, sometimes within a few weeks' time, in the market value of its currency. Such a country required a means of financing its current-account deficit as well as its official interventions in the foreign-exchange market, insofar as it chose to influence the market rate of its currency. In some countries, a large part of the current-account deficit was covered by a net capital inflow. Sometimes the inflow resulted mainly from external factors; in other cases, it was the coincidental consequence of domestic tight-money policies aimed at combatting inflation.

In countries with a deficit on both current account and private capital account, however, the external payments imbalance had to be financed in some manner that required decisions (active or passive) in the field of reserve policy and general economic management. Some of the smaller industrial countries (e.g., Sweden) followed a relatively traditional course in drawing upon existing reserves. Others which possessed large monetary reserves and have relatively high ratios of foreign trade to gross national product (e.g., Belgium, the Netherlands, and Germany) were confident that their currencies would ride fairly smoothly in the foreign-exchange market, but thought it highly important for their trade-oriented economies to establish a common floating arrangement, within agreed margins, with their close trading partners. Since these countries did not expect to sustain large reserve losses or significant changes in currency relationships with their neighbors, or even with the dollar, they found it congenial to conform generally to the broad rules for floating that had been proposed by the Committee of Twenty (except, of course, for the basic deviation inherent in the close linkage with partner currencies, as in the European "snake").

As for the United States, its reserve strategy during the period under review reflected considerations similar to those of the Benelux-German-Austrian group, but with some evident differences. The United States did not organize its own "snake," and its foreign trade is still a small (though increased) percentage of GNP. For this reason, the United States could be relatively stoical about fluctuations in dollar exchange rates within the range that seemed likely to occur. Although its stock of owned

reserve assets was low relative to the size of its economy and to the potential size of its net external imbalances, the United States expected that capital inflows and outflows would about balance themselves during this period. Furthermore, the United States authorities did not attach importance to the level of reserves under a regime of floating exchange rates, and assumed that, if the overall accounts did produce a surplus or deficit despite movements in exchange rates, the imbalance could be financed by a decline or rise in dollar liabilities to foreign official institutions.

Some of the larger countries that were facing major and prolonged adjustment problems not confined to the oil crisis (e.g., Italy and the United Kingdom) were reluctant to commit their limited reserves to support the exchange rates; they shied away from the risks and engagements involved in a joint float. Yet they were also unwilling to allow market pressures on the floating market to force their currencies below certain limits.

Emphasis must be placed, however, on the fact that the policies followed by countries in 1974-75 made extensive use of measures that acted as supplements or alternatives to the use of their owned monetary reserves. These measures divide into those which mobilized additional financial resources to augment official reserves and those which reduced the amount of the imbalance (surplus or deficit) to be financed. The latter category includes the foreign-exchange and capital restrictions imposed by some countries, including several important industrial nations. Although the Federal Republic of Germany withdrew in 1974 most of the special capital-import limitations it had introduced in 1971-73 and the United States chose the beginning of 1974 to dismantle the disincentives and limits on capital export that had existed since 1963, several other countries moved in the opposite direction. France strengthened and extended its controls on outward capital movements, the United Kingdom tightened up on capital export and re-imposed drastic limits on tourist expenditures abroad, and Japan and Italy increased controls to differing degrees on capital outflow. Switzerland experienced a strong inflow of funds for investment or security reasons that contributed to the upward pressure on the Swiss franc and was not discouraged by the prolonged appreciation of the franc. The Swiss authorities re-imposed controls and disincentives, some of them at severe penalty levels, against many types of financial inflow.

In contrast to capital movements, merchandise trade was maintained relatively free of restrictive measures in the main industrial countries, partly as the result of commitments newly made in the OECD and IMF to avoid beggar-thy-neighbor trade policies. The avoidance of trade re-

strictions by the European Community members was perhaps even more directly attributable to the fact that some of their currencies were not floating against each other but were mutually pegged; furthermore, their trade within the Community is a substantial share of the members' total commerce, and members may not restrict it.

From the beginning of the oil crisis, oil-importing countries could foresee that their balances on current account would deteriorate significantly. As noted above, a number of them decided to augment their official monetary reserves by recourse to borrowing abroad in order to finance anticipated deficits. In addition to the smaller developed countries and the many less developed nations that sought foreign credits, the list included such leading industrial nations as the United Kingdom, France, and Italy. Some of the borrowing was accomplished by industrial firms or by domestic banks, which, with official inspiration or blessing, borrowed abroad for the purpose of investing or relending the foreign currencies at home. The governments of these industrial nations also borrowed extensively on their own account.

Except for Italy and a few small countries that sought credits from central banks or governmental authorities, and apart from the credits drawn from the International Monetary Fund, most of the funds borrowed by governments were obtained from private financial sources in the international markets. While the total amount so mobilized is not measurable with exactness, the aggregate for the industrial countries was certainly substantial. Building upon relatively firm figures for Italy, the United Kingdom, and France, total official borrowing by industrial countries may be estimated at roughly $15-$17 billion in 1974.

Certain consequences of this resort to official and officially inspired private borrowing abroad can be discerned. Despite the fact that OECD member countries sustained a striking $36 billion deterioration in their combined current-account balance from 1973 to 1974, the monetary reserves of those countries nevertheless showed a slight increase for 1974. Part of the drop in their current-account position was offset by increased net inflows of capital from the nonindustrial world, but borrowing also sustained the reserves of industrial nations. It must be recognized that the bulk of the amount borrowed officially was obtained from private banking institutions, either in international monetary centers or in the Eurocurrency markets. The additions to reserves which central banks of debtor countries obtained in that manner, therefore, did not involve transfers of reserve assets from other countries' official institutions but rather shifts from the banking sector. Since the proceeds of these credits became

available (without having been purchased in the foreign-exchange markets) for settling deficits and conducting intervention operations, their use reduced the degree of exchange-rate depreciation which the borrowing countries' currencies would have sustained in their absence.

Of the global increase in countries' official reserves in 1974, nine-tenths was in the form of foreign exchange, it was noted above, rather than other reserve assets. Similarly, a high proportion of the credits extended to governmental borrowers was issued in foreign currencies by the creditor banks, including those operating in the Eurocurrency markets. This process of transmediation between the banking sector and official monetary authorities largely explains the observations above that the growth of total reserves in 1974-75 did not result to any great extent from deficits on the part of "reserve currency" countries, as it had in 1969-73, and that it was traceable in large part to the external financial policies of industrial countries generally.

The practices followed by national authorities since March 1973 throw some light also on their preferred choices among different reserve assets. As mentioned before, the composition of countries' reserves among the four categories has remained virtually unchanged, with SDRs accounting for about 5 per cent and currencies and gold continuing to constitute the bulk of owned reserve holdings. As for borrowed reserves, it has been noted that these acquisitions were obtained in national currencies, largely from the banking sector. Even in their borrowings from the regular facilities of the IMF, member countries in 1974 took 99 per cent of their drawings in currencies and 1 per cent in SDRs (IMF, 1975, Table I.7). Gold has not been purchased by the major financial powers for several years; they have not bought it from the private market as a matter of principle and have not bought it from each other as a matter of practice. The SDR, sometimes called "paper gold," has thus far emulated metallic gold in the relative infrequency with which it has been used for official settlements.

These facts stand in contrast to the joint or individual statements issued periodically on both sides of the Atlantic about the desirability of reducing the reserve status of both gold and national currencies. Predecessors of the SDR—gold, sterling, and the dollar—possessed a transferable status in private market channels as well as in direct official transactions. Without attempting here to identify all the factors determining present country preferences for one reserve asset or another, it will suffice to observe that maintenance of market and official usability is one of the many difficult technical and policy problems involved in devising a satisfactory substitution plan.

The Evolution of Reserve Holdings

The term "international monetary system" is a short-hand means of referring to the financial complex that connects the several national monetary areas at any given period. In all periods, this complex tends to be a strange *collage* of different materials and media of the financial arts. It consists of stationary and moving parts, of institutional arrangements, of agreed rules or tacit understandings defining the scope for independent conduct by national monetary authorities and providing for some degree of consultation or cooperation. In more specific language, the main components of any international monetary system include the exchange-rate relationships among the various currencies, the processes through which those relationships are altered, the mechanisms of effecting international transfers, and the means by which international imbalances (surpluses and deficits) are financed during times of instability. Under the dynamic conditions in which the monetary system operates, the reserve assets held by the national authorities in the major countries have, until now at least, played an active operating role or a standby function, assisting the authorities concerned to carry out their domestic and external economic policies.

The functioning of reserves and other instruments of policy to finance the balance of payments under floating rather than fixed rates demands an examination. One arrives at this imperative from either of two pertinent directions: (1) In the late 1960s, the years that led up to their decision to call for reform of the then-prevailing monetary order, both the academic community and the major financial powers devoted extensive attention to the question of how to assure an adequate *growth* of reserves for official purposes. (2) In academic and official discussions about possible alterations of the system, the advocates of fluctuating exchange rates argued that floating rates would *reduce* the need for reserves.[1] How, then, have the quantities of reserves in fact evolved? What has happened to the distribution of reserves among individual countries? What has happened to their composition? What do reserve movements indicate concerning the behavior of the monetary system? What related policies are currently followed by the monetary authorities?

In order to provide the factual background, I have assembled data on the level of official reserve holdings, as well as on the geographic distribution and types of reserve assets held. For the most part, the focus will be

[1] The extensive literature on the adequacy of official monetary reserves or liquidity and on alternative proposals for dealing with the perceived problem of how to increase the supply of reserves is impressively documented by Williamson (1973).

For references to the expectations about the effect of fluctuating rates on the need for reserves, see Machlup (1973); Marris (1970); and Mikesell and Goldstein (1975).

upon the gross reserves owned by the respective national monetary authorities, with only selected references to their net positions and even fewer to the foreign claims and liabilities of the private sector. This conforms to the accepted practice, which owes much to the discussions in the 1960s, of defining the official monetary reserves (or external liquidity) of a country as those resources that are readily available to its monetary authorities for the purpose of financing temporary deficits in its balance of payments and influencing its market rate of exchange.[2] Because of their wide use and general acceptance, the data series of the IMF have been employed. Thus, a country's total international reserves comprise the four categories recognized by the IMF—official holdings of gold, SDRs, foreign exchange, and a country's reserve position in the Fund.[3]

The world total of international monetary reserves held by the authorities in individual countries at the end of 1965 amounted to $71 billion (Table 1). This was barely 30 per cent greater than in 1955, despite a decade of very rapid expansion of real gross national product, an even higher growth rate of merchandise trade, and the restoration of a substantial degree of currency convertibility (for nonresidents) in the industrial countries. In 1970, however, global reserve stocks, which had been rising at moderate annual rates of 2 to 4 per cent during the 1960s, began to rise at a sharply accelerated rate. There followed a period of sustained high increases. In little more than two years, the volume of reserve holdings climbed by 92 per cent, from $93.6 billion at the end of 1970 to $159 billion in December 1972 and to about $180 billion in March 1973. Reserves increased more gradually through the rest of 1973, but they surged upward again in 1974 to reach $220 billion by the close of the year and $230 billion in June 1975.[4]

The "world total" of official reserves, of course, is an aggregate which has only limited meaning for most purposes and which is the sum of differing movements in the holdings of individual countries or groups. Reserve holdings of Japan and the countries of industrial Europe rose markedly throughout the period from 1970 through the first quarter of 1973, a movement that reflected the imbalance in international payments which prevailed during the period between those countries jointly, and

[2] For more extended discussions of the issues involved in wider or narrower definitions, see, for example, Machlup (1962) and Brown (1964, pp. 2-6).

[3] See the introductory pages of the IMF monthly, *International Financial Statistics*, for further explanation.

[4] In Table 1 and other tables, the data are presented in terms of U.S. dollars rather than SDRs, since published data expressed in SDRs are not available for all categories. Advantages of series in SDRs as against those in dollars are about equal, and the decision was therefore made on grounds of convenience.

TABLE 1

TOTAL RESERVE ASSETS OF NATIONAL MONETARY AUTHORITIES, 1965-75

(dollar figures in billions)

Country or Area	*Dec. 1965*	*Dec. 1970*	*Dec. 1971*	*Dec. 1972*	*June 1973*	*Dec. 1973*	*June 1974*	*Dec. 1974*	*June 1975*
1. All countries	$71.0	$93.6	$131.5	$159.4	$184.0	$183.9	$199.8	$220.4	$230.4
Per cent of total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
1a. Change from prec. period	+3.0%	+18.4%[a]	+40.5%	+21.2%		+15.4%[b]		+19.4%[b]	+9.1%[b]
2. Industrial countries	$53.8	$65.8	$ 94.2	$105.8	$120.4	$115.5	$114.4	$119.9	$123.4
Per cent of total	75.7%	70.3%	71.6%	66.4%	65.4%	62.8%	57.3%	54.4%	53.6%
3. United States	$15.5	$14.5	$ 13.2	$ 13.2	$ 14.4	$ 14.4	$ 14.9	$ 16.1	$ 16.5
Per cent of total	21.8%	15.5%	10.0%	8.3%	7.8%	7.8%	7.5%	7.3%	7.2%
4. Japan	$ 2.2	$ 4.8	$ 15.4	$ 18.4	$ 15.2	$ 12.2	$ 13.4	$ 13.5	$ 14.6
Per cent of total	3.1%	5.1%	11.7%	11.5%	8.3%	6.6%	6.7%	6.1%	6.3%
5. Germany	$ 7.4	$13.6	$ 18.7	$ 23.8	$ 32.3	$ 33.2	$ 34.2	$ 32.4	$ 32.6
Per cent of total	10.4%	14.5%	14.2%	14.9%	17.6%	18.1%	17.1%	14.7%	14.1%
6. France	$ 6.3	$ 5.0	$ 8.3	$ 10.0	$ 11.6	$ 8.5	$ 8.2	$ 8.9	$ 10.5
7. Italy	$ 4.8	$ 5.4	$ 6.8	$ 6.1	$ 6.0	$ 6.4	$ 5.3	$ 6.9	$ 6.7
8. Switzerland	$ 3.2	$ 5.1	$ 7.0	$ 7.6	$ 8.7	$ 8.5	$ 8.4	$ 9.0	$ 8.7
9. United Kingdom	$ 3.0	$ 2.8	$ 6.6	$ 5.6	$ 7.0	$ 6.5	$ 6.7	$ 6.9	$ 6.4
10. Less-dev. areas		$18.9	$ 23.9	$ 32.2	$ 40.0	$ 43.9	$ 62.8	$ 78.9	$ 86.3
Per cent of total		20.2%	18.2%	20.2%	21.7%	23.9%	31.4%	35.8%	37.5%
11. Oil-exporting countries		$ 5.2	$ 8.7	$ 11.2	$ 13.0	$ 14.9	$ 30.4	$ 48.0	$ 55.7
Per cent of total		5.6%	6.6%	7.0%	7.1%	8.1%	15.2%	21.8%	24.2%

[a] Change from 1969.

[b] Percentage change figures from preceding December for 1973 and 1974. June 1975 figure at annual rate.

SOURCE: IMF, *International Financial Statistics*, October 1975 and earlier issues.