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THE PROBLEM OF INTERNATIONAL LIQUIDITY AND THE MULTIPLE-CURRENCY STANDARD

FRIEDRICH A. LUTZ

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
Princeton, New Jersey

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It is the fourth issue in the various series of the International Finance Section from the pen of Friedrich A. Lutz, who was a member of the Department of Economics at Princeton University for fifteen years. He is now Professor of Economics at the University of Zurich, Switzerland, and has been for several years External Advisor of the Bank for International Settlements. Among his books are THEORY OF INVESTMENT OF THE FIRM *(with Vera C. Lutz) and* ZINSTHEORIE (THEORY OF INTEREST).

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FRITZ MACHLUP, *Director*
International Finance Section

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The Problem

THE many plans that have been devised, in the last few years, for a more or less radical change in our international monetary system owe their existence to the fear of their authors that the international-liquidity reserves will sooner or later become so scarce that the western world will, unless appropriate measures are taken, be forced to follow a deflationary policy—with all the disastrous consequences which such a policy entails.

The argument—by now well known to every economist—is, in a nutshell, this: Gold production adds far less to the monetary gold stock than is required for the latter to keep pace with the expansion of international trade or Gross National Product of the western world. Therefore, the dollar reserves of countries other than the United States must continuously expand in order to make up for the growing deficiency of gold reserves. An increase in dollar reserves, however, would require the United States to run a deficit in its balance of payments. Even if the surplus countries had, up to now, been taking the accretion to their foreign-exchange reserves entirely in the form of dollar balances, they could not be expected to continue doing this once American dollar liabilities rose to an amount several times that of the American gold stock. As it is, the monetary authorities are even at present not willing to accumulate dollar balances to the extent of the whole of their countries' balance-of-payments surpluses, so that such surpluses cause, in part at least, a loss of gold for America. Clearly, then, the United States cannot afford to go on running a deficit indefinitely. But if it does not do so, there is bound sooner or later to be a scarcity of international reserves in the western world.

For the purpose of the present discussion, I accept this diagnosis of the fundamental weakness of the present gold-exchange standard; but I feel I must at least add that I do not think the scarcity of international reserves is a very imminent problem. Nonetheless, it is the economist's job to think in time about possible solutions for the dilemma to which I have referred. This sort of thinking has produced such a galaxy of

proposals for fundamental changes in the present set-up, that it may appear to many as a pleasant relief to find somebody advocating changes that do not involve radical departures from what we now have, and do not either require new international institutions or burden existing international institutions with new functions.

Possible Solutions

There are, in principle, only three solutions to the problem of a threatening shortage of international reserves.

The *first* consists in the adoption of a system of freely flexible exchange rates—a very neat solution inasmuch as it removes the problem of the adequacy of international reserves from the scene. However, I shall not discuss this method of dealing with the problem. I have been in the past, and still am, an advocate of flexibility of exchange rates at least within certain rather broad limits. But the resistance of the monetary authorities to flexible rates is, in almost all countries, so strong that this system has no chance of being adopted in the foreseeable future.

The *second* solution is an increase in the gold price. Again, I shall abstain from discussing this solution in detail. But I should like to make one or two remarks about it.

First of all, I feel pretty sure that the raising of the gold price by the United States would not lead to any change in exchange rates, since the European countries would follow suit. It would, therefore, not contribute to an improvement in the American balance of payments. But this does not mean that the measure would not make sense. If the price of gold were raised sufficiently, the United States could, with the consent of foreign monetary authorities, convert the latters' entire dollar balances—inclusive of the amount that might in the future be turned over to these authorities by commercial banks—into gold. If this happened the dollar would cease to be a part of international reserves. And if, with luck, gold production in the west (plus, possibly, sales of gold by Russia) were to rise high enough to cause the rate of growth of the monetary gold stock to match that of, say, international trade, it would not be necessary to use the dollar for reserve purposes even in the future. Now, since the monetary authorities consider gold the final and therefore most desirable international-reserve medium, and since gold is the only medium that constitutes *net* international reserves—that is, reserves not matched by corresponding liabilities, as is the case with dollar balances—surely we should admit that this second solution is not as stupid as many economists would have us believe.

If nevertheless I do not advocate a rise in the gold price, it is mainly for two reasons.

The first is the scramble for gold, and the confusion in the foreign-exchange markets, which will occur as soon as there is serious discussion of a move to a higher gold price. The intention to change the gold price cannot under present conditions be kept secret.

The second reason is the inflationary danger which the large increase in reserves of all countries with substantial gold stocks would entail. This danger need not arise in the case of the United States if its dollar liabilities were converted into gold so that its reserves increased very little or not at all. Elsewhere, however, the danger of inflation would undoubtedly be quite serious, because the balance of payments would, for a time, cease to act as a brake against inflationary policies, while at the same time the book profits obtained from the devaluation might tempt the authorities to engage in deficit-financing which would in those circumstances be costless. Although the exercise of monetary discipline on the part of the countries concerned could undoubtedly prevent such inflationary consequences, I am not optimistic enough to believe that this is what would in practice occur. And if they were not prevented, the stimulating effect on gold production, which is a necessary part of the whole scheme, would sooner or later cease to make itself felt. The upward revaluation of gold might then have to be repeated. For reasons which are rather obvious, recurrent increases in the gold price would, however, make the gold or the gold-exchange standard unworkable.

The *third* solution consists in widening the foreign borrowing potential of countries by making provisions for countries with surpluses in their balances of payments to lend to those with deficits. Strictly speaking, it need not be the countries with current surpluses that do the lending; it may be done by other countries possessing large international reserves, accumulated out of past surpluses. Nevertheless, I shall for simplicity's sake consider the lending countries as identical with countries having current balance-of-payments surpluses. The principle is best made clear by an extreme example:

Suppose an international institution were created similar to the defunct European Payments Union, but on a worldwide basis. All the surplus countries would "deposit" their surpluses with this institution, while all the deficit countries would run into debt with it to the extent of their deficits. Since the sum of the deficits always equals the sum of the surpluses, no balance-of-payments crisis and no shortage of international reserves could ever develop. This "system of unlimited credit" would, of course, be excessively inflationary, since each country would have an interest in drawing on the resources of other countries by running a deficit, and no country would be obliged to keep a strict watch on its balance-of-payments position. I do not, of course, advocate this system;

I only mention it because it shows better than any other how the shortage of international reserves can be overcome by international borrowing and lending.

Now, all the plans that have been devised to solve our problem—except, of course, that of flexible rates and that of a rise in the gold price—are variations on this theme of increasing the borrowing potential of member countries by inducing or forcing those in strong foreign-exchange positions to lend to those in weak ones. This is so, whether the I.M.F. arranges for standby credits, or whether a world bank à la Triffin is set up with the power to create an international currency, or whether, à la Maudling, the I.M.F. acts as a depository for the currencies which surplus countries do not wish to hold.

In case the I.M.F. widens the borrowing potential in the way described, it is immediately evident that the solution of our problem consists in the readiness of the countries with strong foreign-exchange positions to lend to those with weak ones. If a world bank à la Triffin is created, this is perhaps less obvious, but nevertheless true. If this world bank grants a credit to country A by creating a bancor deposit in its favor, and country A then turns this deposit over, in payment for its deficit, to country B, which then keeps the deposit, it is of course country B which is really giving the credit to country A. Or suppose that, under the Maudling scheme, a participant in the Mutual Currency Account decides not to convert the currency of another participant into dollars and then into gold, but deposits it—after notification of the debtor—with the Account in exchange for a deposit in some currency unit of fixed value in terms of gold. What really happens here is that the depositing country lends to the country whose currency is deposited in the Account.

From what has just been said it should be clear that the borrowing capacity of a country ought to be regarded as part of its international reserves. The I.M.F. is following this principle when it adds a country's gross I.M.F. position, i.e. its drawing potential, to its foreign-exchange and gold reserves. But this is not sufficient. Consider the case of the United States. The willingness of other countries to lend to the United States by accumulating dollar balances is certainly an essential part of that country's international liquidity. Without it, the United States would have lost gold much more rapidly than it has and would therefore have been forced long before now to bring its balance of payments into order. And the fear that this willingness may not last indefinitely surely contributes to the feeling that the international-liquidity position of this country is deteriorating.

Now it is important to realize that if a country makes use of this bor-

rowing potential, the effects will be different according to which of two types of lending is involved. One type does not entail the creation of any international reserves for the lender, the other type does. And I suggest that a good way of grouping these plans is according to whether they provide merely for an increase in the borrowing potentials of deficit countries by inducing other countries to lend to them, or whether they go further than this and provide for a type of lending which creates reserves for the lender. To the first group belong such measures as the raising of I.M.F. quotas and the granting of standby credits by countries in strong foreign-exchange positions, as was done at the 1960 meeting of the I.M.F. in Vienna. The Maudling plan and the extreme scheme outlined previously—the system of unlimited credit—also belong to this group. The second group comprises the Triffin and a number of similar plans. In the Triffin plan the emphasis is clearly not so much on the increase in the borrowing potential of the participating countries as on the creation of more units of international currency, consequent upon the borrowing countries' making use of this potential.

Looked at from the point of view of the above classification, the situation under the present gold-exchange standard is this: Through the I.M.F. the borrowing potential of all participating countries has been increased; and when any country borrows, the corresponding lending by other countries is of the "neutral" type, which does not create reserves for the lenders. The United States, however, has in addition a borrowing potential which others do not have. It consists in the willingness of other countries to acquire dollar balances; and the acquisition of such balances is representative of the second type of lending, namely, that which creates international reserves for the lender.

It is worth noting that those who have devised schemes to meet the danger of a future shortage of international reserves by expanding these reserves, rather than by merely widening each country's borrowing potential, do not wish to see an expansion of such reserves in the form of an accumulation of dollar balances such as might occur under the system we have at present. The reason is, as I pointed out before, that such an accumulation is, as a rule, accompanied by some loss of gold by America and leads in any case to a reduction in the United States' ratio of gold to short-term liabilities. Thus, as long as the present gold-exchange standard exists and the American deficit continues, the "conservatives" are usually at one with the "reformers" in holding—paradoxically it may seem—that surplus countries should lend in a form that does not increase international reserves as a way of meeting the threatening shortage of such reserves. And pressure is brought to bear on countries with strong foreign-exchange positions to "lend more," as the

phrase goes. We may notice that in public discussions the acquisition of dollar balances is hardly ever considered lending. What those who ask for "more lending" really mean is that the surplus countries should lend in a manner which does not create dollar reserves; that is, they should either lend long to the United States or they should lend—whether long or short makes no difference here—to third countries. In both cases the surplus in the balance of payments of the lending countries and the deficit in the American balances of payments would be correspondingly reduced, compared with what they would have been if no such lending had taken place.

Now, this method of equilibrating balances of payments through "neutral" lending—or lending that does not create reserves—by the surplus countries, which in its extreme form is equivalent to the "unlimited-credit system" outlined before, is not any more sensible than the method of persuading, or compelling, surplus countries to lend to deficit countries in a manner that does create reserves.

The theory underlying both methods has its roots in mercantilism. It regards the countries with balance-of-payments surpluses as "natural" capital exporters, implying that such surpluses are a sign of wealth. People, who in any other context would have ridiculed the mercantilist view, are apt to talk in this fashion. The theory sounds especially strange coming, as it often does, from those who think of an accumulation of dollar balances not as "lending to the United States" but simply and solely as "addition to foreign-exchange reserves." There are, however, others who do recognize that the acquisition of dollar balances reflects an excess of domestic savings over domestic investment and is a form of lending; and some of them are, I think, inclined to argue that there can be no harm in requesting a country which already has such an excess and is lending to change the form of this lending.

We should beware of accepting this point of view. For, while a surplus in the balance of payments does, it is true, signify an *ex post* excess of domestic savings over domestic investment, it does not necessarily signify an *ex ante* excess. An indication that the two things do not always coincide is the fact that interest rates are frequently higher in the surplus (lending) countries than in the deficit (borrowing) countries. Surely the explanation of the surpluses has to run in terms of the cost levels in the surplus countries being too low relatively to the cost levels in the others. And in such circumstances the right course of action is for the surplus countries to get rid of their surpluses not by long-term lending, but by measures which raise their imports and reduce their exports (and for the deficit countries to cooperate if possible by acting the other way round). This seems to me to be the proper

cure for balance-of-payments troubles, and not the "unlimited-credit system."

One last point before I proceed to the more constructive part of this discussion. Once we realize the importance of a country's borrowing potential as part of its international liquidity, we cannot attach much significance to the customary calculation of the international-liquidity reserves of the western world which equates them to the sum of the various countries' gold stocks plus the dollar balances of countries other than the United States plus the sterling balances of the outer sterling area. For such a calculation makes no allowance for the borrowing potential of the various countries. It is, as I said before, not sufficient just to add their drawing rights on the I.M.F. On the other hand, there is no way of knowing the sum total of all the borrowing potentials. Moreover, we cannot ignore the fact that an increase in the dollar balances of foreign countries may reduce the remaining borrowing potential of the United States, or, that is, the willingness of foreign countries to accumulate further dollar balances, in which case international liquidity, for the world as a whole, has not risen to the extent indicated by the usual statistical measure. The point I am now making is not, it should be noticed, the same as the point made by many other critics of such statistics, namely that these statistics neglect the fact that dollar and sterling balances are matched by corresponding liabilities of the United States and Great Britain, and therefore fail to give a true picture of net international liquidity which, they argue, should be taken as equivalent to the monetary gold stock alone.

Now if we do not accept, as a solution to the problem of international liquidity, the principle that countries should be compelled to lend, either in a way that creates reserves or in a way that does not, and if we are also of the opinion that the present system cannot last indefinitely, what way out is there?

The Multiple-Currency Standard

In a series of lectures delivered in May 1961, in Amsterdam,* I proposed that the western countries now holding dollar balances should in the future keep their international reserves not exclusively in one country's currency but in many, and that the United States too should follow a policy of holding other countries' currencies in addition to gold. Not every country, of course, would be eligible to serve as a key-currency country. No central bank would, I imagine, be prepared to hold the

* Published under the title *The Problem of International Equilibrium*, by the North-Holland Publishing Company (Amsterdam, 1962).