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RESERVES, RESERVE CURRENCIES, AND VEHICLE CURRENCIES: AN ARGUMENT

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This is the fifty-fourth in the series ESSAYS IN INTERNATIONAL FINANCE *published from time to time by the International Finance Section of the Department of Economics in Princeton University.*

As in the case of Essay No. 47, this is not an essay, strictly speaking. Rather, it takes the form of a dialogue, reproducing a discussion held by Robert V. Roosa and Fred Hirsch in London on January 28, 1966.

Robert V. Roosa is now a partner of Brown Brothers, Harriman and Co., Bankers. He has served in several financial positions in the U.S. Government, including Vice President of the Federal Reserve Bank of New York and Under Secretary of the Treasury for Monetary Affairs in the Kennedy and Johnson Administrations. His published works include MONETARY REFORM FOR THE WORLD ECONOMY, *1965.*

Fred Hirsch is an Assistant Editor of THE ECONOMIST, *and his views on international monetary questions are often expressed in the pages of that weekly. He has also written numerous signed articles in other financial journals. He too published a book in 1965,* THE POUND STERLING: A POLEMIC.

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FRITZ MACHLUP, *Director*
International Finance Section

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HIRSCH

Dr. Roosa, one could regard you in a sense as the architect of the whole system of attempting to deal with international currency problems on an *ad hoc* basis. You successfully used your influence in the Kennedy Administration, when it came in, not to go even for a scaled-down version of something like the Triffin Plan, but rather to build up your piecemeal defenses in various ways. One wonders how you feel about that in hindsight from your present nonofficial position. Do you have any regrets about this; do you think it might have worked to have gone for something bigger then?

ROOSA

No, I am just stubborn enough to think even now that this was the better approach for that time. I would not want, however, to leave the impression that I was the architect. I happened to sit where the thoughts and capabilities of a lot of other people could be brought together. At that point I did have an opportunity to form my own judgment as to how real progress could develop. It was my view that major change in the liquidity arrangements of the world would depend upon experience gained from a series of new methods to be introduced step by step. This would also, or could also, bring an evolutionary change in the states of mind of those people who, whatever happens, are going to be the principal monetary authorities in the various countries, not only in the leading countries, but also in the less developed.

From the beginning, in the Kennedy Administration, we stressed that our own position was going to be essentially as you have described it. We began by taking two major steps that we thought were the most critical at that stage: first, the introduction of what we called the "ring of swaps," bilateral arrangements with a number of central banks of other countries; and, second, developing enough agreement among most of these same countries to provide for the establishment of the General Arrangements to Borrow in connection with the International Monetary Fund.

We thought of these, both for the world payments system and of course for ourselves, as defensive mechanisms that would meet the most pressing risks of the moment. We thought they also combined within them the opportunity for bringing about a kind of common experience, a common approach that would be the basis for more ambitious efforts later on. We also thought that it was better to wait for the introduction of any more major and lasting substantive changes of a structural kind until the immediate strains of those earlier years in the payments positions of the United Kingdom and the United States had at least been temporarily surmounted or, hopefully, overcome.

HIRSCH

Have you any reaction to Arthur Schlesinger's reported comment that you rather enjoyed walking the tightrope?

ROOSA

I have not seen the comment, I am sorry to say. I intend to learn all I can about those days from reading the books that are now available and so well written. But if that is what he said, I suppose I should agree that, without enjoying this in any gleeful or reckless sense, I did feel that it was essential to develop friendly, harmonious working relations as a basis for the international financial cooperation that we were going to need more and more in future years. I deeply felt that this could only be built in ways that did require a kind of personal involvement of the officials on all sides and one that gave them all a sense of participating in a successful kind of experiment. In that, there was a kind of enjoyment for all of us. To turn that around, I think it was important to remove the impression that we were desperate defenders of a beleaguered position, and to let us realize that, whatever might be the defensive aspects of this, we were really sharing in an opportunity to test out some of the building blocks for what could eventually be a major creative effort.

HIRSCH

Yes, quite. You are saying, as I understand it, that one had to go slow at the beginning. One had to build up what one had in international cooperation in order to advance to more radical schemes later on. Now I could follow you in this if no country were officially pressing for radical reform, if all were agreed on the inevitability of gradualness. Yet this has not been so in one of the key disputes of the past three years—the dispute between the Anglo-Saxons and the Continentals on the role of the reserve currencies. Here the Continentals are radicals: they would be rather better disposed toward certain elements of the Triffin scheme than they are to the building up of the *ad-hockery*. This is the basic French attack on the privileged position of the dollar or, in a different form, on the irrational elements in present reserve creation, depending as it does very largely on the particular deficits of the United States. In this matter of diagnosis, as a lot of people have said, even the Rueffian position is, ironically, rather similar to Triffin's. So, was not the American refusal to throw the position of the dollar under scrutiny a *handicap* to the emergence of a real international consensus on the road to reform? And is that not at the present moment one of the factors that is making it difficult to get a reform that is worth having?

ROOSA

Part of our reason for going slow, behind or surrounding the various reasons I have already given, was that we felt, and I still do feel, that there is no single clear pattern yet visible for any ultimate answer. We wanted to learn something more from experimentation before we had to reach the stage of taking a full commitment in any one single direction. And in thinking of a full commitment, probably the greatest single change that the United States could ever be involved in, as the whole system is being reappraised, would be a decision to give up the burdens and responsibilities that go with any of the gains of being a reserve-currency country.

We were very mindful of the responsibility side of this. We were concerned over what would happen to the normal and existing patterns of payments and of reserve transactions if the United States were even to cast a shadow of doubt over our current readiness to continue the servicing role we have performed for so long. What would happen to the whole pattern of prevailing world trade and capital movements? We felt it was prudent for us and helpful to everyone else to avoid any action that would impair at that time the continued functioning of the monetary system, centered on reserve currencies and buttressed by the Monetary Fund, as it then was. Any such impairment, we felt, would be throwing too much on one possible path of further evolution before we had had the experience to be certain which way to move. I think, in that vein, we are still learning.

I would not agree with some of the things you have written implying that there is no necessary connection between the functioning of a currency as a vehicle or trading currency and its serving as a reserve currency. Mind you, in diagrammatic logic it is possible to show them quite separately. And through gradual changes over time—and here I mean decades, not merely months—it may turn out that a currency can fulfill the basic trading requirements that a growing world economy needs without also serving as a reserve currency. But I am still very fearful that a deliberate cutting of that link would actually impair the performance of both functions. This seems to me true for the dollar at least; I hesitate to speak for sterling. The function of the dollar as a trading currency would be impaired if the option of its use as a reserve currency were to be denied or denigrated.

Here is where I find the greatest difference from some of the views expressed by some Continentals. I have no objection at all to visualizing an evolution of the system in which there would be no enlargement in the supply of dollars serving as a reserve currency. But there is a great difference between having that occur as a byproduct of other changes and having it imposed as a precondition for such changes. Money rests so much on confidence—confidence in all kinds of countries and among all kinds of people. That is why I feel that the generation of acceptable, and continually acceptable, international monetary claims is one of the most awesome prospects ever contemplated for the joint action of nations. We have to be reasonably sure to create an environment in which this can move forward for a while experimentally before we cut off the other elements on which we have previously been dependent.

What I object to is starting a new arrangement with the commitment that dollars must be removed from official reserves. I do not at all rule out the possibility that we may very well find, and I hope we will find, that the role of the dollar as a reserve currency diminishes as a result of the actions that evolve; not because it has been forced on us.

HIRSCH

I am very glad to hear you put it in this way, that you hope that the role of the dollar as a reserve currency will diminish. Certainly, I would totally agree with you in rejecting some of the more extreme Continental notions that one should lay down hard and fast rules about this, and that one should bar people from holding certain forms of money. The one thing we have learned in the whole history of money is that money is what people like to hold. So that it is absurd, domestically and internationally, to say that they must not hold this or that as a monetary claim. But might I take you up on this connection, which is of real practical importance, between the reserve-currency function and your vehicle-currency function?

If one takes sterling, the general position has been that the reserve-currency function, measured by the total balances in external official hands, was mainly built up during the war, and has not really moved much since; since then one has just had the overhang. Having that very large overhang of official liabilities has unquestionably been a factor in the vulnerability of sterling. And that vulnerability of sterling, at least since 1957, has quite clearly cut down the private commercial use of sterling, its use as a vehicle currency. In 1957, there was a general curb on foreign overdraft credits during that crisis; world traders turned to Euro-dollar financing as an alternative. More recently, we had a great tightening up on long-term financing, even in financing of foreign firms that are actually in Britain.

In the case of the dollar, you had in mid-1963, as a result of similar pressure then, the interest-equalization tax greatly cutting down the use of the dollar in New York issues. This has since been extended to some bank loans; and you have had non-tax, voluntary restrictions on the extension of external bank loans as a whole. Now this is where Triffin argues—and personally I do not see any flaw in the argument—that in this sense the function of a currency as a reserve currency, producing the overhang of these official liabilities, actually impedes the private-financing function. How do you see that?

ROOSA

No, I would not accept it. My own feeling is that the reserve-currency role, despite its many problems for us, has been an integral part of the trading-currency role. The separation would be as delicate as operating on Siamese twins. As for these more recent developments, I think that the restrictions that the United States has imposed, and perhaps many that the United Kingdom has imposed—although I cannot be as sure of this—were largely the result of the failure of our own economies to accomplish adequately and soon enough the other parts of the overall adjustment process that would confront any country in our general economic circumstances, whether or not such a country had a reserve-currency role. I also do think it is true that the uses that we, at least in the United States, made of our reserve-currency position were in some measure abuses. I doubt if that would ever happen again. We were going through the first period, for the United States, in which the great capacity of the world for utilizing reserves was being in some measure (I would not say wholly, by any means) overused by the United States. Our own deficits were running too large for too long. From that side, I would say that much of the European criticism has a grain of truth in it.

I do not believe that this is an inherent characteristic of a reserve currency, certainly not a currency that is now, after a few years' experience in this, subject to a multilateral surveillance that will reinforce our own resolve to keep our overall accounts in reasonable balance. Moreover, the developments that necessitated temporary resort to restraints on the flow of capital were not in our case unique characteristics of a reserve currency. I think perhaps some of the same difficulties that we are mentioning here in terms of impairing the use of the currencies would have occurred in any case because of our own size and the complexity of our trade and payments relations with the rest of the world. They occurred because our external-payments positions were weak and had been weak for some time, not necessarily because there had been a significant outstanding overhang of sterling balances or dollar balances.

HIRSCH

But the overhang does make it worse, would you not accept that? The overhang makes you that much more vulnerable to private-banking claims than if you do not have an overhang.

ROOSA

Well, let me ask you a question: where is the overhang? Which of the present sterling balances would you think you could reach with an effort to consolidate, and, if you reached them, what gain do you think you would have? Whose balances are these that are causing this further aggravation of a problem—which might be explained on the ground that I have already suggested?

HIRSCH

Well, put that way, you never can tell. You can never identify the potentially troublesome balances in advance, any more than you can ever identify in advance which particular banking depositor is going to rush to the door first. You can not tell; all you can say is that there are these nervous banking depositors and at any given time they are in danger of all storming the door at once. And the very fact that they are in danger of all storming the door, even if they do not actually get there, worries other people, and adds to the trouble of the situation. This is not fancy; it is very recent London history. Therefore, what I think one must do is have an open-ended possibility for any of these banking depositors, the official holders of reserve currencies, to transfer their reserve-currency claims into something like an IMF deposit. Personally, I would make this entirely voluntary and open-ended; and in that way, to use your terms, create a self-qualifying situation. If it is the case that none of your official holders, in practice, are troublesome holders, and if it is the case that they do not want to shift their funds at a time when they fear for the currency—well then you will not get any transfer of sterling claims into the IMF.

There is no difficulty in seeing from official U.K. figures that reserve-sterling countries *have* been shifting out of sterling at awkward times—admittedly still on a pretty small scale. But to say that the overseas sterling-area balances add to sterling's burden does not rest on these actual switches taking place on any large scale. It must surely be the case, almost as a matter of sheer mathematics, that the more claims you have on a bank with a given cash reserve, the more vulnerable it becomes to the acceptance of any additional claims.

I think the key point is really the following—and in a sense I feel that, over the years and especially now, you are maybe shifting slightly towards this position: There is now widespread agreement that the reserve-currency function, which after all is simply a means of transferring international debts through paper claims, is a function the IMF or some such body could perform, once you had sufficient trust. But the other function, of supplying and putting money into the international bond market or supplying a short-term trading credit, is one the IMF cannot perform. And therefore, if we are working on a limited cash position—very tenuous for the United Kingdom, less tenuous but still limited for the United States—then it seems to me that it is highly important to arrange for a shift-over of the official function as quickly as we can, just in order to safeguard this private function; because, as we see at this moment, it is on this "private international bond market" side that we are getting the real liquidity squeeze now.

ROOSA

Yes, I would agree—with qualifications. Certainly there must be a point at which the supply of either sterling or dollars can become too large to be compatible with its continued functioning as both a reserve and a trading currency; and that definition of too large is determined by the behavior of those who hold the currency. Speaking broadly, I think the present supplies of sterling or dollars are not too large—do not contain any distinguishable overhang—under ordinary conditions.

But I think that there is another source of vulnerability, that will exist no matter how we rearrange this system, and this is the crucial one. Surely there are times when—regardless of the general stability of the existing outstanding volume of funds of both kinds—conditions of panic, fear, excitement, concern, and agitation, will be created through some outside cause. Such conditions lead to a run from all currencies, with a convergence of pressures on those trading currencies which serve as a common denominator for transactions in all the others. It is at such times that you get a shift from one form of trading currency to another, or from one form of reserve asset to another. This is what

I call the risks of coexistence; they are always going to continue; and, therefore, we are going to have to find ways of minimizing their impact. They are necessarily inherent in having internationally acceptable trading currencies that must be interchangeable or redeemable in one or more forms of reserve assets.

I do not just want to play with semantics here, because I am basically agreeing with you that there is a limit. I question whether in the case either of sterling or the dollar now there is any calculable or discernible overhang, in the normal day-to-day affairs, of sufficient significance to be a major influence on the current performance of either currency. Now you would disagree; but I would say that the essential thing at this stage, when the world still needs these currencies performing as well as they can in both roles, is to avoid actions which seem inherently designed to create a presumption for holders of sterling or dollars that they have acquired a kind of second-class asset—that the monetary authorities, therefore, are finding a way for these currencies always to be shunted aside.

I also think that until we have reached the stage of introducing, with adequate safeguards, universally acceptable new international monetary-reserve assets, an approach toward resolving this supposed overhang problem runs a risk (if your view is accepted, and I do not myself concede the need) and raises another kind of question. For, in effect, you are proposing an open-ended facility through which holders of sterling or dollars, whenever they think they have too many, can unload them on some multinational facility supported by others. Will that not, at the least, cast new grave doubt on the readiness of the two countries issuing these currencies to take the steps necessary to maintain their own strength? Do we really want, could we ever expect to get, that kind of blank check?

HIRSCH

But the transfer would involve an eventual repayment obligation by America or Britain to the Fund, though these obligations must not be set on a rigid or inflexible schedule. Might I just put this specific point to you? Supposing the Continentals declared here and now that in relation to the new unit of reserves now being discussed, they would agree that it should be possible to establish such units as IMF deposits, by the transfer of officially held sterling or dollar balances; and supposing they proposed this without any highly constrictive arrangements on repayment by Britain and America, that is, permitting, say, repayment from the proceeds of future surpluses, as I know the Italians had in mind. How would you personally react to such a proposal? Would you think that this would be the time to take it up?

ROOSA

No, I can be consistent on that score. I would, as you know, have opposed it in 1961 or 1962. I would still oppose it, because I feel that the next major step in monetary reform must be one that adds to the joint and mutual responsibility of the European countries with us, in an orderly and determined way. I do not want undue privileges for us, nor an arrangement which offers any one monetary authority the privilege of "dumping" dollars into a pool financed by all the others.

HIRSCH

I am not certain that I quite follow that. The countries that will do the financing, if any extra financing is needed as a result of additional claims for other, scarce currencies in the IMF, will be the surplus countries, and I know of no system where it is otherwise. Ideally, there would be no "pool" that required financing: the IMF deposits would be the accepted medium of international settlement. I am also rather uncertain whether you see the reserve-currency role as a burden or as a privilege. Sometimes you rather imply that it is both.

ROOSA

Yes, let me just say a word about that. I have just reread some comments that you wrote in *The Banker* a little while ago in which you questioned this, and I would like to try to make a little clearer my feeling that the reserve-currency role is both a burden and a privilege.

You suggest there that the United States, after all, has been able to gain a great deal of extra financing and to keep a very large gold reserve that otherwise would have been paid out, given its large deficits, if the dollar had not been a reserve currency. That is true. But the pressure that we have had in the United States, in terms of achieving correction of the imbalance of payments, has in itself been passing through two phases. It is quite true that in the early stages we avoided gold outflows, we were able to improvise other things that minimized gold outflows, because countries were so dependent on the use of the dollar as a reserve currency that they wanted to cooperate in maintaining the gold reserve that helped (in the way that gold reserves do) to lend additional credibility to the currency itself for all the purposes it serves. But as the deficits continued, and continued large, for a variety of changing reasons, the position shifted the other way. We entered a second phase where the current accrual of dollars arising from the cur-