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The Supply of International  
Liquidity

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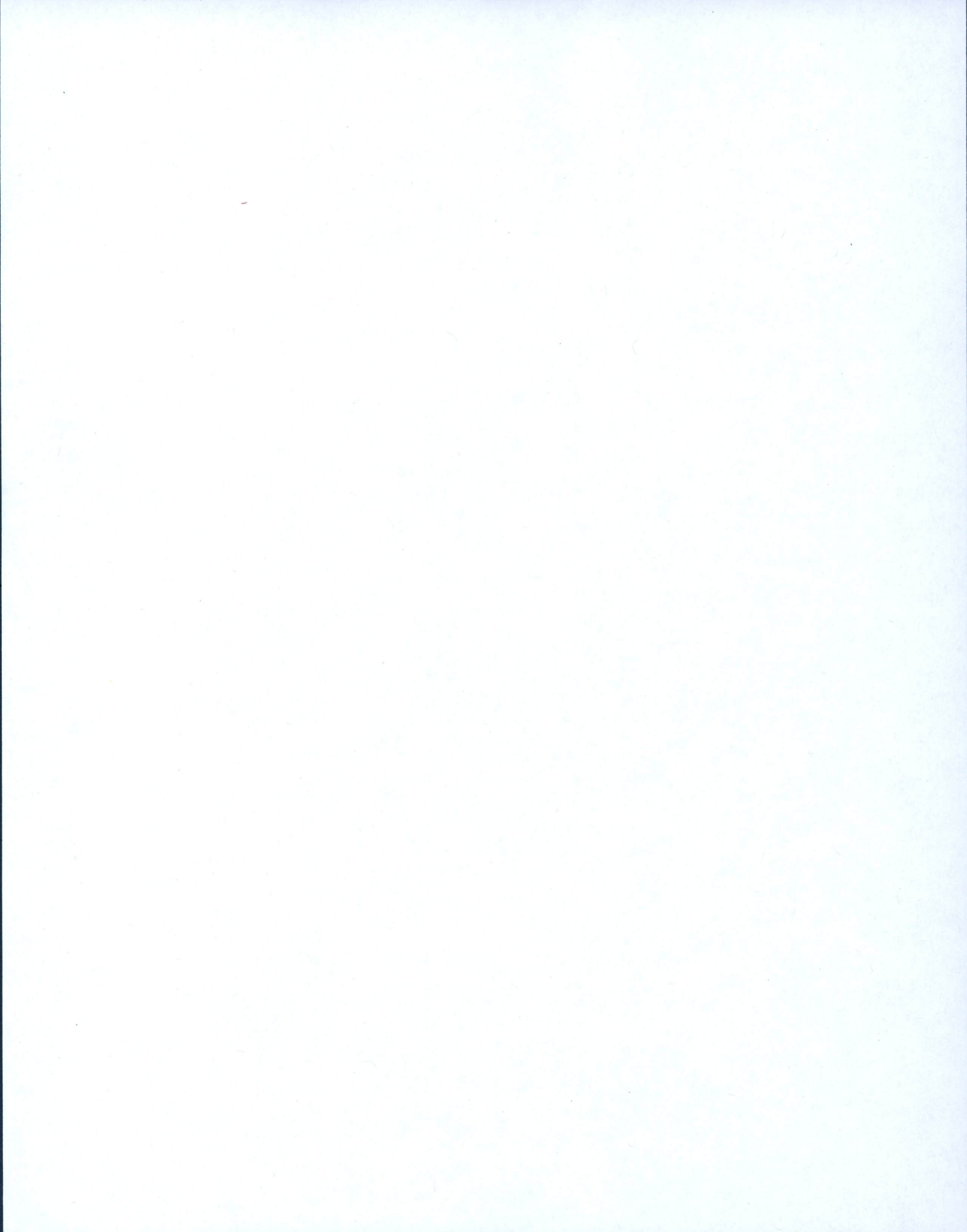
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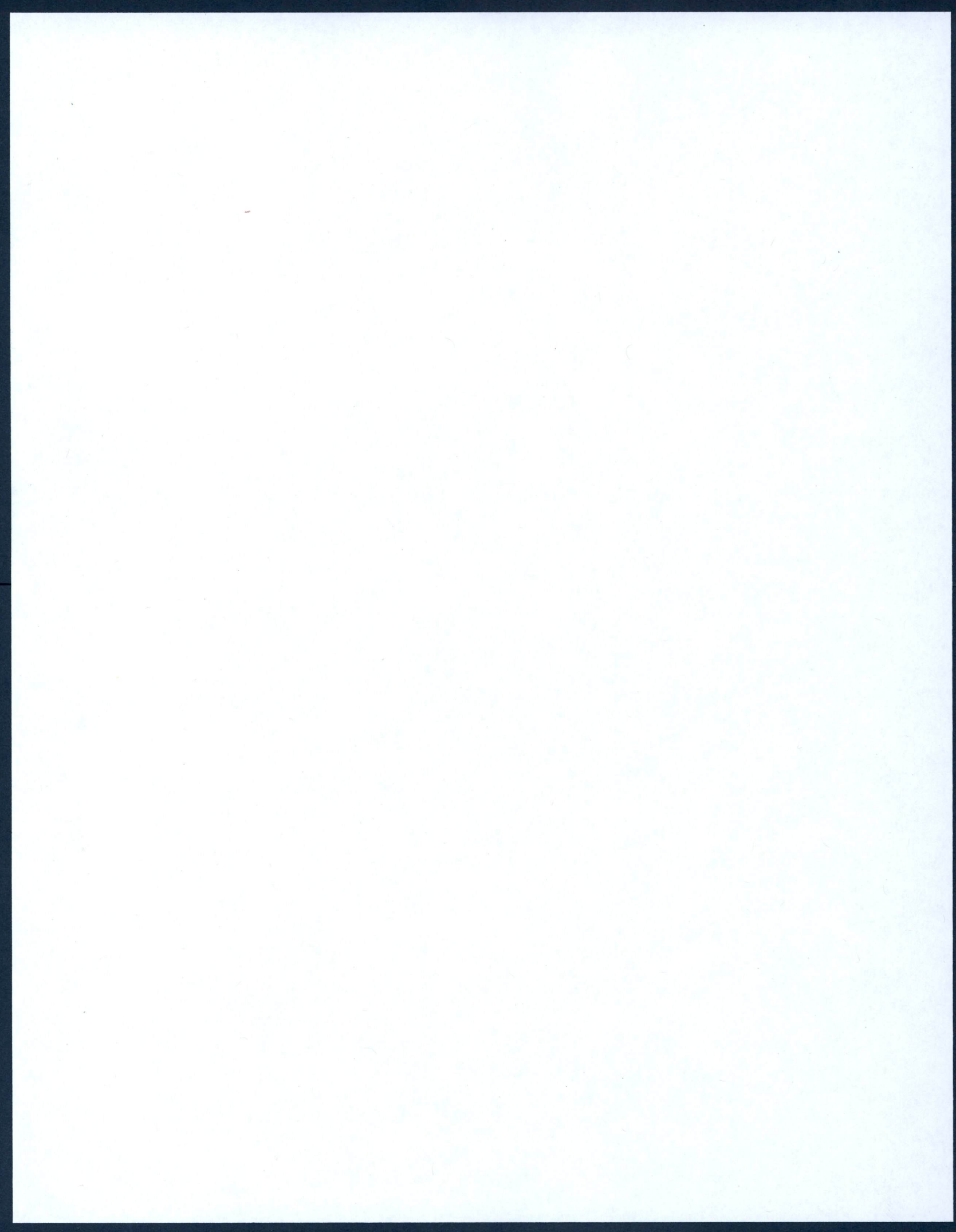
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### THE SUPPLY OF INTERNATIONAL LIQUIDITY

In this discussion, attention will be paid to the following points:

- (a) the need for international liquidity, which will be seen to be exceedingly flexible;
- (b) the supply of international liquidity under the current institutional set-up; ample at present, this supply is nevertheless dependent on further creation of liquidity by the international reserve centers;
- (c) the problems arising out of such further creation of international liquidity by the international reserve centers;
- (d) the possibility of adjusting the supply of international liquidity to the variable needs for international liquidity with the smallest degree of interference in present practices of international payments.

### THE NEED FOR INTERNATIONAL LIQUIDITY

(1) A comparison is often made between the need for transaction balances in national currency and the need for international liquidity. This comparison is valid only to a very limited extent. The transaction balances in national currency serve primarily to finance differences in the time pattern of receipts and expenditures. The national reserves of foreign exchange, on the other hand, are needed only after many buyers and sellers of foreign exchange have first been matched on the foreign exchange market. The result is a seasonal movement in foreign exchange reserves, which in general is of only slight magnitude.

Hence the need for international liquidity has its origin not so much in the transaction motive as in the precautionary motive. Reserves of international liquidity must finance disequilibria in the balance of payments. These may originate in two ways: first, the equilibrium between national means and national expenditures may become disturbed, and second, a temporary disequilibrium may arise in the national price and cost level as a result of errors in wage policy or of shifts in international demand.

(2) It follows that the need for international liquidity cannot be expected to show a relative decrease as international trade increases and the time pattern of international receipts and expenditures steadies. Rather, it must be anticipated that, if trade increases, the consequences for the foreign exchange reserves of a given error in policy will increase proportionately.

Although a relationship can thus be established between the volume of international trade and the need for international liquidity, this need is also dependent on a number of other factors. To the extent that international credit can be more easily obtained, smaller reserves will be

sufficient, because in case of need a country can draw upon these credit facilities, thus spending, as it were, its foreign exchange reserves a number of times. In addition, the need for international liquidity is to a large extent influenced by the kind of calamities against which one wishes to keep precautionary balances. If the anticyclical policies of the most important countries are in harmony, and large and important structural changes do not occur, then relatively small foreign exchange reserves will suffice. If, on the contrary --to take the other extreme-- a depression of considerable size should occur in an important country, then even relatively large foreign exchange reserves are probably hardly sufficient.

(3) It may thus be concluded that the need for international liquidity is extremely variable. Accordingly, the supply of international liquidity should be flexible. It is thus desirable to move in the direction of a system of international payments in which actual foreign exchange reserves are relatively small (which would reduce the temptation to over-spend), but which in case of need is capable of extending international credit or of creating international liquidity on a large scale.

#### THE SUPPLY OF LIQUIDITY

(4) Although it is therefore difficult to make an exact estimate of the need for international liquidity or its annual increase, it is nevertheless clear that the value of gold becoming available annually for monetary purposes is so much smaller, that this source of international liquidity alone is insufficient. According to estimates of the I.M.F., monetary gold may be counted on to contribute an amount of \$ 700 million a year in the near future to the stock of international liquidity. The total quantity of gold, dollars, and pounds sterling in the possession of non-banker countries (all countries, that is, except the United States and the United Kingdom) amounted to \$ 42,500 million at the end of 1959 (see accompanying table). Taking into account the desire of these two international reserve centers to add to their own gold stock out of these \$ 700 million, the non-banker countries cannot reasonably expect to increase their monetary gold stock by much more than 1 per cent of their present liquidity holdings per annum. Since one must reckon with an increase in world trade of between 3 and 6 per cent per annum, it cannot be doubted that additional creation of international liquidity will be necessary.

It must be emphasized that we are here concerned with a long-term problem. As a result of the decline in international trade in 1958 and the large American balance of payments deficits in 1958 and 1959, the quantity of gold, dollars, sterling, and "EPU units" in the possession of non-banker countries, expressed as a percentage of the total imports, has increased from 47 at the end of 1957 to 57 at the end of 1959. This has occurred in spite of the fact that the "EPU's" have meanwhile lost their liquid character and consequently were not included in the 1959 figure. There can thus be no question of any present shortage of international liquidity. On the contrary, one must fear for the inflationary consequences

of the existing surplus of international liquidity. But this very excess in the creation of international liquidity has called attention to the precarious position in which the international reserve centers may find themselves in the long run if the present system of creation of international liquidity is continued without change.

The difficulties under consideration here could of course be solved by an increase in the price of gold. This would not only increase the physical production of gold but also its value. However, this would cause not only a (desired) increase in the creation of international liquidity but also an (undesired) increase in the existing mass of international liquidity, since the existing monetary gold stock would increase in value as well. Among the many other cogent arguments against an increase in the gold price, the following may be mentioned:

- (a) such an increase would benefit the wrong countries in a very arbitrary way;
- (b) it is impossible to determine the proper amount by which the gold price should be raised;
- (c) balancing the amount of international liquidity with the changing need for international liquidity is completely impossible by this means;
- (d) it would be a grotesque waste of productive resources to have additional unnecessary gold-mining activities carried out for the solution of the problem of international liquidity.

In the following paragraphs, attention will therefore be paid to some ways of solving the problems that arise from the creation of international fiduciary money.

#### FIDUCIARY MONEY

(5) Every monetary system that contains a truly fiduciary element gets into trouble as soon as faith in it is lost. This holds equally for the international monetary system no matter whether fiduciary moneys are created by an international central bank to be founded for the purpose or, as at present, by one of the existing international reserve centers (the United States or the United Kingdom). For as soon as the money-creating body provides a true addition to the supply of international liquidity --which means that its demand deposits exceed its gold stock-- it can no longer fulfill all its obligations at one and the same time. Hence it has become defenseless against a run. On the international plane this became clear at the time of the run on sterling in 1931. This failure of the sterling banker resulted in the disappearance of the fiduciary element in the international monetary system in the thirties and in an increase in the price of gold.

In the case of renewed creation of international fiduciary money, this time of dollars, we will only be really safeguarded against a repetition of such events if the "depositor countries" together accept a collective commitment never to let their dollar holdings drop below the amount of the "fiduciary issue" of the international reserve center, that is, the amount with which its demand deposits exceed its gold stock. Such a commitment not to reduce collective dollar balances would have to be distributed among the

depositor countries in proportion to their gold and dollar reserves. But dollar balances would of course remain freely transferable, and each individual country could convert dollars into gold if its total gold and dollar reserves should decline. Only the "club" as a whole would accept a commitment not to let its dollar balances drop below a certain amount. Indeed, this commitment would only formalize the situation that would already exist in fact in our hypothetical case. For the counter-value in gold simply would not exist to the amount of the fiduciary issue, and consequently conversion into gold would be a physical impossibility. It would therefore perhaps be preferable formally to accept this consequence. In the same way the convertibility of legal tender into gold has at last had to be restricted in the national payments systems after some sad experiences, recognizing in this way the physical impossibility for central banks to adequately fulfill their previous conversion duty.

(6) In international payments systems as well the necessity of arrangements to restrict gold convertibility has been accepted fairly generally. The sterling banker has assured himself of acceptance of a commitment by the members of the sterling area to keep nearly 100 per cent of their foreign exchange reserves in the form of sterling balances. The contributions of the I.M.F. to the supply of international liquidity rest on commitments of a similar nature. For to the amount of the transactions undertaken by the I.M.F., the countries whose currencies are being drawn have to accept drawing rights on the I.M.F. in exchange for the foreign exchange debts they take upon themselves. A similar commitment is also the primary feature of the international central bank proposed by Professor Triffin. He suggests a commitment, at first amounting to 20 per cent of gross gold and foreign exchange reserves. It may be stated that the creation of international liquidity by the United States through further acceptance of short-term liabilities --which would as a consequence before long exceed the American gold stock for the first time-- can in the long run only be undertaken safely if the depositor countries agree collectively to keep dollar balances of at least the amount of the "fiduciary issue" to be created by the United States.

Such a commitment, which the members of the BIS might well be willing to accept in exchange for a gold-value guarantee, would not at all be an expression of mistrust against the dollar banker or proof of a supposedly weak position of the United States. It would rather be a guarantee that no depositor country, in attempting to jump the gun, would start a run on the dollar. Such a run could have far-reaching effects because there exists no central international institution which could guarantee the liquidity of the solvent dollar banker.

(7) Just as in the case of national monetary systems, so in the case of international systems safeguards must not only be established against deflation as a result of a shortage of international liquidity. Attention must also be given to the danger of inflation as a result of an excess of international liquidity.



In the sterling system this guarantee against excessive creation of liquidity exists in the fact that a deterioration in the relation between the gold and dollar reserves of the United Kingdom on the one hand and the sterling balances of non-residents on the other leads to financial tension. Under the I.M.F. system, the guarantee against an excessive use of the means of the Fund exists in the conditions governing the use of the Fund's resources. On this point the Triffin proposal for an international central bank contains the provision that the bank has to regulate its granting of credit in such a way that the supply of international liquidity increases by 3 per cent per year. Deviations from this standard require the assent of a qualified majority, that becomes more and more difficult to obtain.

In regard to the dollar system, attention must also be paid to this matter. One possibility would be that depositor countries would commit themselves not only to maintain a minimum part of their dollar and gold reserves in dollars, but also to keep a minimum part in gold, while being free to choose between gold and dollars for the remaining part. The management of such arrangements would of course have to be a subject of regular discussion, possibly within the framework of the BIS or the I.M.F.

#### SUPPLY AND NEED OF LIQUIDITY

(8) In paragraph 3 the conclusion was reached that the need for international liquidity is extremely variable in magnitude. The I.M.F. offers the possibility of meeting a sudden increase in the need for international liquidity. For the Fund can at a critical moment put international liquidity at the disposal of deficit countries. It does not really matter whether one argues that the Fund achieves this by increasing the supply of liquidity or by increasing the velocity of circulation of existing liquidity. Put either way, the transactions of the Fund lead to increased possibilities of balancing the accounts.

As a result of the complicated structure of the I.M.F., it is not possible to estimate the capacity of the Fund to provide equilibrating finance in one clearly determinable amount. For this capacity is also dependent on the distribution of surpluses and deficits among the member countries. According to Triffin the capacity of the Fund may be put at the moment at \$ 5 billion. This amount seems sufficient for the time being to take care of sudden changes in the need for international liquidity.

The purpose of the Fund is, however, the granting of "revolving credits". It can therefore take care of sudden shortages of liquidity but not of a gradual increase in the need for liquidity.

(9) The combination of the I.M.F. with an arrangement that would enable the safe creation of international liquidity by the United States seems however to offer reasonable possibilities to provide both for the gradual increase in the need for international liquidity and for sudden changes which might occur therein.

The transactions of the I.M.F. could also to some extent compensate

those changes in the supply of international liquidity which would be caused by accidental balance of payments surpluses and deficits of the international reserve centers. Such surpluses and deficits are determined by many factors, most of which are only very indirectly related to the need for international liquidity. An example of such compensation can be found in recent experiences. In 1956-57 when the United States had a surplus in its balance of payments and the need for international liquidity had suddenly risen as a result of the Suez crisis, the Fund sold foreign exchange on a large scale. Now that the American surpluses have given way to deficits, these additional facilities tend to disappear by the re-purchase of their own currencies by member countries.

(10) The purpose of the foregoing discussion has been to try to provide an outline of the problem which an adequate supply of international liquidity may present in the long run, without spelling out the details of solutions that might be proposed. If it is true that the supply of monetary gold becoming available is smaller than the annual increase in the need for international liquidity, then it is clear that we are in fact faced with a long-term problem, even though there is no cause for concern in the immediate future. This is a matter central banks should think about. If they do not do so and an emergency should arise in the future, then a solution is likely to be found along lines proposed by those who have thought about it.

One vital element will have to be part of any solution: co-operation between the responsible national monetary authorities. "Money does not manage itself" - nationally or internationally.

T. de Vries

Composition of and Changes in the supply of international liquidity  
(millions of dollars, rounded off at \$ 50 million)

O m s c h r i j v i n g	Composition at the end of		Changes during:						
	1958	1959	1958	1959	1959				1960
					1st qu.	2nd qu.	3rd qu.	4th qu.	
1. Gold production outside Russia			1,050	1,150	250	300	300	300	.
2. Gold sales by Russia			200	250	150	100	0	0	50
3. Hoarding of gold(-) by private persons and industrial consumption			- 600	- 700	- 250	- 150	-150	-150	.
A. Monetary gold outside Russia (1 through 3)	39,500	40,200	650	700	150	250	150	150	200
5. Addition(+) to or absorption(-) of international liquidity by the United States	- 7,900	- 5,350	3,300	2,550	600	1,100	750	100	300
on account of									
i. increase(-) in U.S. gold stock	(-20,600)	(-19,500)	(2,250)	( 1,100)	( 100)	( 750)	( 150)	( 100)	( 50)
ii. participation(-) by U.S. in I.M.F.	(- 2,750)	(- 4,150)	( 0)	(-1,400)	( 0)	(-1,400)	( 0)	( 0)	( 0)
iii. accumulation(+) of dollar balances by non-residents of U.S. 1)	( 15,450)	( 18,300)	(1,050)	( 2,850)	( 500)	( 1,750)	( 600)	( 0)	( 250)
6. Addition(+) to or absorption(-) of international liquidity by I.M.F. 2)	2,000	850	100	-1,150	50	- 200	50	-1,050	-100
B. Gold and dollars outside U.S. and I.M.F. plus unused drawing rights (A. + 5 + 6)	33,600	35,700	4,050	2,100	800	1,150	950	- 800	400
7. Addition(+) to or absorption(-) of international liquidity by U.K.	5,450	6,850	- 600	1,400	- 300	0	50	1,650	-100
on account of									
i. accumulation(-) of gold and dollar reserves by U.K.	(- 3,050)	(- 2,750)	(- 800)	( 300)	(- 100)	( 0)	(-100)	( 500)	(- 50)
ii. increase(-) of unused drawing rights on I.M.F.	(- 750)	(- 50)	( 0)	( 700)	(- 200)	(- 50)	( 0)	( 950)	(- 50)
iii. accumulation(+) of sterling balances by others than U.S. 3)	( 9,250)	( 9,650)	( 200)	( 400)	( 0)	( 50)	( 150)	( 200)	( 0)
8. Accumulation(+) of balances with E.P.U. 4)	1,350	0	100	-1,350 <sup>4)</sup>	-1,350 <sup>4)</sup>	0	0	0	0
C. Gold, dollars, sterling and EPU units outside U.S., U.K. and I.M.F., plus unused drawing rights of others than U.S. and U.K. (B. + 7 + 8)	40,400	42,550	3,550	2,150	- 850	1,150	1,000	850	300

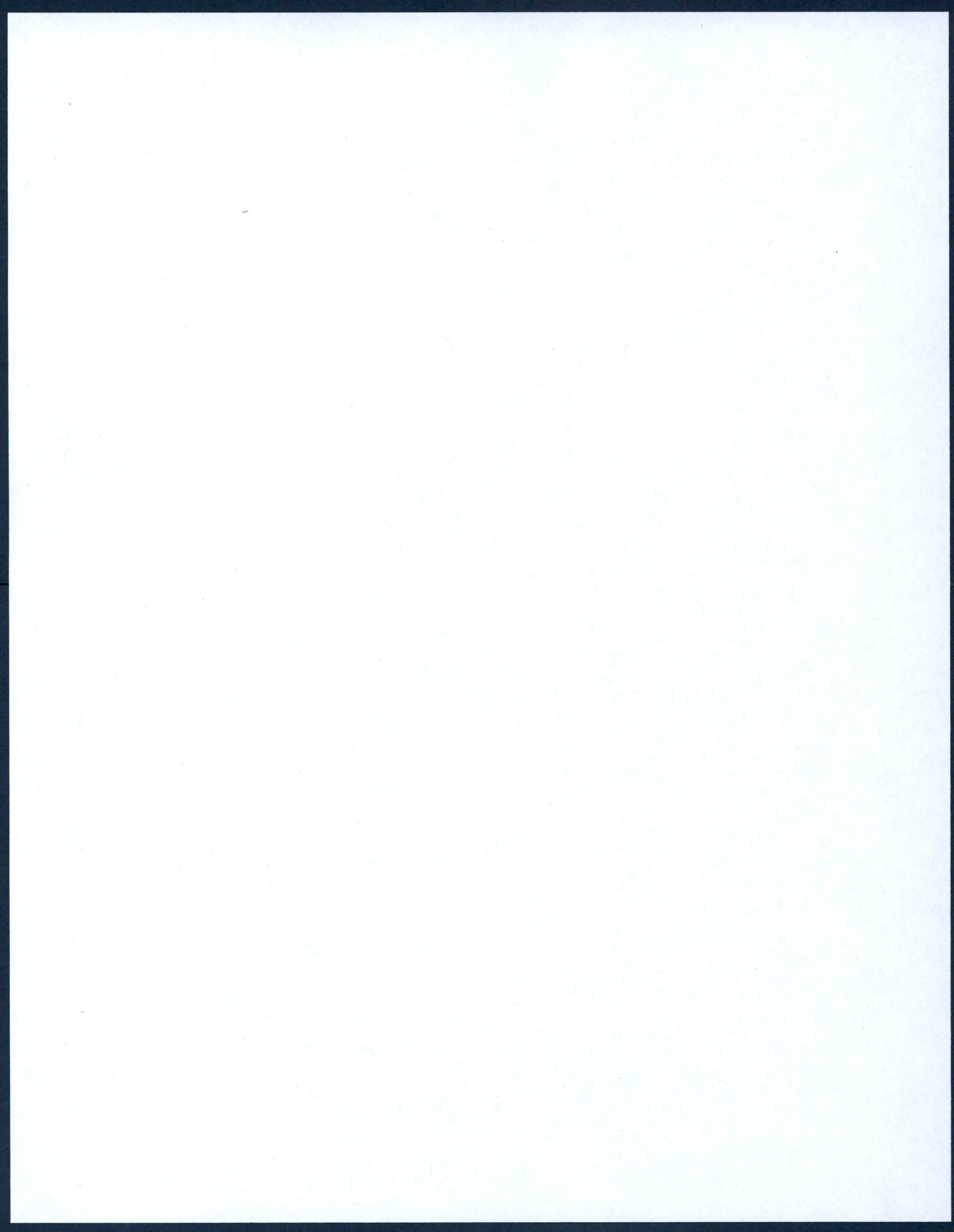
- 1) Including balances held by I.M.F., EPU and B.I.S.
- 2) Participation of U.S. plus unused drawing rights of other countries minus gold and dollars held by I.M.F.

Explanation:

Unused drawing rights at I.M.F. are defined as the unused gold quotas of other countries than U.S. plus available stand-by credits. Since both can be freely disposed of, unused drawing rights have been regarded as a part of the existing supply of international liquidity.

- 3) Excluding balances of international bodies.
- 4) Those claims on EPU which, as a result of the termination of the Union, were converted into bilateral debt relationships as of January 15, 1959, have been considered thereby to have lost their foreign exchange character and accordingly their character of international liquidity as of that date.

Sources: International Financial Statistics, annual reports of B.I.S., I.M.F. Staff Papers, Annual Bullion letters and Annual Bullion Reviews of Samuel Montagu & Co Ltd.





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