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Background and Objectives

Origins of the Study

WORK on this study began several years ago in response to two somewhat conflicting trends in thinking about international monetary and payments problems. There was, on the one hand, a widely held view that the growth of international liquidity—freely convertible and universally acceptable means of payment for transacting international business and settling balances between countries—was not assured in sufficient size and regularity to serve the needs of international trade and the orderly expansion of the world economy. On the other hand, there was a growing apprehension that the additional liquidity being generated consisted too largely of dollars and was too dependent on continuing deficits in the U.S. balance of payments as a means of supplying additional dollar balances to foreigners.

There was perhaps a certain contradiction in these two views. If the addition to foreign holdings of dollars was not excessive in relation to the presumed secular rise in international liquidity requirements, there need not have been serious grounds for worry about the chronic U.S. deficit. In the extreme view,[1] however, there was no compromise: to meet liquidity needs solely or mainly by increasing foreign dollar balances presupposed a chronic payments deficit by the United States such as to weaken confidence in the dollar and undermine the system. Coupled with this view was the belief that the system as it operated was easily subject to abuse, that it did not impose discipline on the United States comparable to

1. As expressed notably by Robert Triffin in *Gold and the Dollar Crisis,* New Haven: Yale University Press, 1960.

that faced by other countries in deficit, and that the amount of dollars which foreign central banks found themselves compelled to accept could, and probably would, exceed their needs and wishes.

Under these conditions, there was a need to know more about the composition, motivation, and growth prospects of foreign holdings of liquid dollar balances. The question refers particularly, of course, to foreign private holdings, since central banks were obliged under the prevailing system to absorb any dollars not otherwise taken up on the foreign exchange market.

What, then, were the reasons foreign commercial banks, business enterprises, and individuals chose to hold dollars? What purposes did they serve? How much growth might reasonably be expected? How firmly were the dollars held or, conversely, how much of a threat did the mounting volume of foreign liquid claims pose to the ability of the United States to defend the exchange value of the dollar?

In brief, questions of this sort presupposed an analysis in terms of what has come to be called a portfolio adjustment model. What were the preference functions of foreign holders of dollars? What were the key variables? How did the variables move?

Along with the buildup of foreign liquid claims on the United States came the curious phenomenon of the rapid growth of the Eurodollar market—a market for borrowing and lending American dollars operated outside the United States by foreign banks, including foreign branches of U.S. banks. What were the reasons for this development? How did the Eurodollar relate to the American dollar in terms of the functions served by both in international trade and finance? How did the Eurodollar market relate to flows of liquid funds to and from the United States? Was the Eurodollar market in some sense a part of the U.S. payments problem? Did it mitigate or accentuate the problem?

The original aims of this study, initiated by J. Herbert Furth in 1967, have been overtaken by events, culminating in the confidence crisis in the spring of 1971, the formal suspension of convertibility of the dollar in August 1971, and the devaluation of the dollar and revaluation of other leading currencies in December 1971, and the further depreciation of the dollar in February 1973. It is worth noting that, when the crunch came, American-owned dollars proved just as flight-prone as foreign-owned dollars, to judge by the size of unrecorded capital outflows as mirrored in the errors and omissions item of the U.S. balance of payments. As might have been known from confidence crises that have afflicted other currencies in earlier times, this recent experience suggests that countries in basic payments disequilibrium have to be mindful not only of their liabilities to, and claims on, other countries but of the potential mobility of domestic funds as well.[2]

Though affected by these recent developments, the original aims of the study nevertheless remain relevant to the evolving world monetary and payments system. They are pertinent to an understanding of the past and to an evaluation of future problems and prospects. Unfortunately, we are still far from being able to provide the answers, or to command the data, required of a properly developed set of portfolio adjustment models. We can go only part way, throw some light on key issues, and help to frame the questions on which further research is needed.

Questions to Be Considered

The principal subjects dealt with in this report fall into three categories, explored in the following three chapters respectively.

First, in Chapter 2, we have found it necessary to review and to some extent reconstruct the statistical record with respect to foreign holdings of dollars. As far as foreign balances in the United States —i.e., American dollars—are concerned, we can be relatively brief. This is particularly true inasmuch as the U.S. Department of Commerce has recently modified the composition and arrangement of its figures along lines that seemed essential to us when this study was

2. This was, in fact, a major weakness in the "liquidity balance" used by the Department of Commerce for many years as the principle measure of balance in the U.S. international accounts. It regarded increases in both private and official liquid dollar assets by foreigners as a potential threat to the exchange value of the dollar. Consequently according to the "liquidity balance," all increases in foreign holdings of liquid dollar assets tended to increase the U.S. deficit and vice versa. Logically, however, both U.S. resident and nonresident dollar holdings can be exchanged for foreign currencies in the exchange market. Hence, whether an international transaction increases or decreases the vulnerability of the dollar to depreciation in the exchange market is not a proper criterion for the selection of an accounting balance for measuring equilibrium.

undertaken. Now the criteria and presentation seem to be sufficiently close to our own views so that only minor modifications in the Department of Commerce format are made here. Even so, we have found it essential to bring into consideration other highly relevant data, hitherto little used, on the role of multinational banks and the important part they play in this country's dollar liabilities. We have in mind both the internal obligations of U.S. parent banks to their foreign branches and those of the U.S. branches and agencies of foreign banks to their home offices abroad.

Also in Chapter 2 we explore the statistical intricacies of the Eurodollar market. Since deposits in that market are not claims on U.S. residents, one may ask if they really need to be taken into account. We argue that they should be, given the close similarity in some of the important functions served by the Eurodollar and the American dollar. We then trace the development of Eurodollar deposits, by main categories of holders, on the basis of statistics rather different from those made familiar in the annual reports of the Bank for International Settlements.

In Chapter 3 we analyze the behavior of foreign dollar holdings by the three major categories of foreign holders, namely, private nonbanks, commercial banks and official institutions. We begin with a brief discussion of the origins of foreign dollar balances, which includes our own contribution to the controversial literature on the generation of Eurodollar deposits. In line with the portfolio-adjustment approach, we have sought to determine the factors that govern the preference functions of foreign private liquid asset holders, which in turn determine the demand for American dollars, Eurodollars, and other currencies. Within the limits of our data we examine the sensitivity of foreign nonbank holdings of U.S. dollars, Eurodollars, and foreign currencies to changes in interest rate differentials corresponding to the three categories of liquid assets. Our modest results suggest that further analysis may prove rewarding, especially if certain data limitations can be overcome. In this chapter we also deal with the interrelationships between the operations of the Eurodollar market and the U.S. balance of payments. The interrelations between the Eurodollar market and U.S. short-term capital movements are strong and subject to quantitative measurement. But the effects of the market on the U.S. basic balance can only be conjectured.

In our concluding chapter we summarize our empirical findings and apply them to certain basic issues relating to the past and possible future international role of the dollar. Since a substantial portion of the international financial intermediation functions of U.S. financial markets has been transferred to the Eurocurrency and Eurobond markets, we explore the implications of the development of these Euromarkets for the international role of the dollar and for the U.S. balance of payments. Finally, we apply our empirical and analytical findings to the problems of international monetary reform currently under negotiation by the Committee of Twenty. In spite of the recent dollar crises, we find that the current position and functions of the dollar may prove difficult, if not impossible, to replace, and may impose an insurmountable barrier to monetary authorities seeking to make the dollar symmetrical with other major currencies in the world payments system.