

III. INTEREST RATES AND U.S. SHORT-TERM LIABILITIES

If there exists a single, dominant, world financial center, a role London fulfilled in the 19th century, short-term interest rates can affect only the amounts of liquid assets which would be kept at home or deposited in London. With two main financial centers today, and a number of smaller subcenters—in Switzerland, Canada, France, etc.—the possibility is opened up for the switching of foreign exchange reserves from low- to high-interest rate countries, or more likely, for simply a building up of balances in one center rather than another as foreign exchange reserves are accumulated, thereby altering the ratio of reserves held in different foreign centers.

In some cases, such movements in reserve holdings would make little or no difference to the financial centers involved; a liquid liability is merely transferred from the name of one country to the name of another in the country losing the balance, while the recipient country experiences both an increase in an asset (in the other financial center) and an increase in a liability. Even when a commercial bank repatriates a foreign asset, it may often mean simply that the liability of the financial center is now to a foreign central bank rather than to a foreign commercial bank.

If, however, a liquid liability of the United States owed to, let us say, a German commercial bank, is moved to London because of a higher yield there, it may mean that the United States loses gold. The British exchange equalization account may prefer to hold gold rather than U.S. securities. And if the German bank moves its asset home, the German authorities may decide to exercise the same option. Thus, while the movement of foreign short-term funds in response to interest-rate differentials is unlikely to affect our overall financial deficit as measured by the Commerce Department presently (this is even true of commercial bank assets as the financial deficit is measured in table 1, but not of nonbank assets), it may affect our gold holdings and thus have an influence on our world economic position.

In table 6, there is presented a summary picture of changes in our liquid liabilities to foreigners for the period from the end of 1956 to the end of 1961. Sixty-five percent of our increased liquid liabilities to other countries from the end of 1956 to the end of 1961 consisted of new liabilities to Europe, and 88 percent of the total increase involved additional liabilities to Canada and Europe combined. Furthermore, 60 percent of the increase in our liquid liabilities to other countries, or about \$3.2 billion, represents new, privately owned dollar assets; only \$2.2 billion of the \$5.4 billion increase has accrued to foreign central banks and governments. Surely the stage has been set for large-scale "switching" operations if foreign banks and private citizens, particularly the former, wish to, or feel compelled to move their liquid assets out of the United States, either in response to interest-rate differentials or to some other stimulus.

In an interesting study of the movement of such funds over the past few years, Robert F. Gemmill of the Federal Reserve System found that the amplitude of the fluctuations about the trend from peak to trough in dollar assets held by foreign commercial banks and other private parties in recent years has been between \$600 million and \$1 billion, suggesting that this is the maximum amount of switching which may take place as a result of interest rate differentials or for other reasons. And he suggests that two other considerations may well have swamped the interest rate factor, in spite of a relatively high correlation between deviations from trend and interest rate differentials, viz: The need to build up working balances consequent upon convertibility, to which I alluded previously, and probably a speculative movement against the dollar in late 1960 and early 1961, which could explain the large absolute decline in privately held liquid dollar assets during this 6-month period.³

Using a slightly different approach, I have tried to analyze the degree of switching of foreign exchange reserves which might be occurring in response to interest rate differentials by considering how the composition of foreign assets around the world has varied with movements in short-term interest rates. Table 7 shows first of all that between 1956 and 1958 foreign central banks and other official bodies tended steadily to increase the ratio of both gold and dollars relative to total foreign asset holdings, and that this ratio was relatively constant through 1959, 1960, and 1961 although there was a movement away from dollars into both gold and other foreign currencies—presumably sterling—dur-

³ Robert F. Gemmill, "Interest Rates and Foreign Dollar Balances," *Journal of Finance* 16 (September 1961), 363-376.