

INTEREST RATES AND FOREIGN DOLLAR BALANCES

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INTRODUCTION AND CONCLUSIONS

Large U.S. balance-of-payments deficits since 1957 have led to substantial increases in foreign liquid-dollar holdings and to a decline of about one-fourth in the U.S. gold stock. These developments have stimulated discussion of the extent to which financial policy, and especially monetary policy, in this country might be influenced by the international reserve position of the dollar. Obviously, a country that acts as an international reserve center and in this role accumulates a large volume of outstanding short-term liabilities to foreigners must take care to insure that doubts do not arise concerning the stability of its currency. Even though a country maintains a high degree of financial stability, however, questions can be raised regarding the effect on its reserve position of countercyclical financial policies, such policies may contribute to the outflow of domestic capital and thereby worsen the country's payments position. In addition, however, concern has been expressed that antirecessionary policies involving low interest rates might put pressure on the reserve position of the United States by bringing about a conversion of foreign-held dollar balances into gold.¹ In this paper, we shall examine the latter problem, attempting to assess the extent to which past behavior of foreign-held balances affords a basis for such concern.

The actual U.S. balance-of-payments deficits since 1957, which have stimulated discussion of the reserve position of the United States, have reflected major developments in U.S. international transactions on both current and capital account. The proportion of these deficits that has taken the form of net foreign gold purchases has reflected the overall payments surplus of major foreign countries, the proportions of their payments surpluses, in the form of additions to official reserves, and the extent to which they hold reserves in gold.² The general conclusion of this paper is that those movements in foreign holdings between gold and dollar assets in recent years which could be attributed to interest-rate changes account for only a very small fraction of total foreign dollar holdings. The main findings upon which this conclusion is based are as follows:

1. There is no basis either on theoretical grounds or in available statistical materials for believing that foreign official institutions adjust their reserve holdings between gold and liquid-dollar assets in response to short-term or cyclical movements in interest rates. This finding is not inconsistent with evidence that such institutions do alter to some extent the composition of their holdings of liquid-dollar assets as changes occur in yields on these assets.

2. There is reason to believe that some foreign private liquid-dollar holdings are drawn down when yields on liquid-dollar assets are substantially lower than yields obtainable in other international money markets and rise when the yield advantages on short-term investments in other money markets disappears.

Foreign private dollar holdings (excluding those of Canada) rose about \$1 billion between mid-1958 and early 1960 and had declined by a somewhat smaller amount by early 1961. During these years, U.S. interest rates moved from a cyclical trough to a peak and then receded to a substantially lower level. These fluctuations in foreign private holdings are greater than the movements

¹ See, for example, Robert Triffin, "Gold and the Dollar Crisis" (New Haven: Yale University Press, 1960), p. 9: "Our huge gold losses of last year [1958] were due in part to such a repatriation of foreign capital at a time when interest rates had fallen here well below the rates available in Europe. They have been slowed down this year [1959] by an extremely sharp rise of interest rates in this country, prompted by our domestic concern about creeping inflation. In this case, external and internal interest rates policy criteria happily coincided, but they may diverge tomorrow. If and when we feel reassured about our internal price and cost trends we may wish to ease credit and lower interest rates in order to spur our laggard rate of economic growth in comparison not only with Russia, but with Europe as well. We may then be caught, however, exactly as the British were in the 1920's between these legitimate and essential policy objectives and the need to retain short-term funds here in order to avoid excessive gold losses."

² See articles on gold and dollar flows in the Federal Reserve Bulletin, March 1959, 1960, and 1961.