Adequate growth of monetary reserves

The last condition for international monetary stability is an adequate but not excessive growth of monetary reserves. An excessive growth of monetary reserves would give an inflationary bias to the world economy; an inadequate growth of monetary reserves would give a deflationary bias to the world economy. On the other hand, if monetary reserves were to grow at about the same rate as international trade and payments—that is, enough to meet payments deficits without unduly hastening or delaying the restoration of a balanced pattern of payments—there would be sufficient monetary reserves, if properly distributed, to induce international monetary stability.

An inadequate growth of monetary reserves could lead to deflation in several ways. In the first place, as the great trading countries would not be able to add to their reserves at the desired rate, even if the pattern of international payments were well-balanced, some of them might try to acquire a larger share of the smaller increment of reserves through excessively cautious fiscal and credit policies. This would hold down world trade and investment, disrupt the pattern of international payments, and compel other countries to follow deflationary policies in order to protect their own reserves or to have any increase in reserves.

In the second place, if the growth of monetary reserves were at an inadequate rate, the aggregate reserves held by the great trading countries would be too small for meeting normal fluctuations in the balance of payments, without seriously depleting the reserves of deficit countries. Under such conditions, the payments deficits that countires would be able to tolerate would be sharply reduced, and countries would be compelled to take harsh measures to avoid the emergency of a payments deficit or to terminate it very quickly when it does emerge. Even credits from the IMF would be not enough to provide countries with the "opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."[1] Indeed, if aggregate monetary reserves were too small and their growth grossly inadequate, many countries would be unwilling to undertake the obligation to maintain fixed parities.

On the other hand, an excessive rate of growth of monetary reserves is certain to impart an inflationary bias to the international monetary system. Although the tie between the money supply and reserves is much looser than it was in the past, so that the growth of reserves need not manifest itself in a proportionate increase of the money supply, the mechanism of international payments would inevitably lead to monetary expansion. That is because with very much larger reserves, deficit countries could unduly delay the restoration of their balance of payments. This would pose an inflationary threat to both the deficit countries and the surplus countries. In the deficit countries, the delay in taking corrective action would permit an inflated demand to continue longer with greater likelihood of its being permanently embodied in a higher level of prices and costs. In the surplus countries, the continuation of payments surpluses for an unduly long period would necessitate the accumulation of unwanted monetary reserves acquired by expanding the domestic money supply. The task of maintaining a disciplined monetary policy and of avoiding inflation would become very much more difficult for the surplus countries.

There has never been a satisfactory system of providing monetary reserves for an expanding world economy. Under the gold standard, the growth of monetary reserves was dependent on the accidents of gold discoveries and gold production. In fact, the world suffered from alternate periods of gold inflation and gold deflation. Under the gold exchange standard, the situation was in some respects better and in others worse. At a time when the reserve currency countries, particularly the United States, had a payments surplus, aggregate monetary reserves actually decreased. In 1946 and 1947, for example, the dollar holdings of foreign central banks and Treasuries fell by over $2.3 billion. On the other hand, from 1958 to 1965, the dollar holdings of foreign central banks and Treasuries increased by over $5.2 billion. Thus, the growth of reserves under the gold exchange standard is to a very large extent an accident of the U.S. balance of payments.

In the present system, monetary reserves consist of gold, dollars, sterling and other foreign exchange, and net creditor positions in the IMF. The growth of gold reserves over the past 15 years has averaged about $500 million a year. There

[1] Articles of Agreement of the International Monetary Fund, I(v).