MONETARY THEORY AND POLICY

Week 5-International Liquidity and International Adjustment

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International Liquidity: Meaning and Aspects

In this topic, we will discuss

1. Meaning of International Liquidity

2. Aspects of International Liquidity

3. Role of IMF in Enlarging International Liquidity.

4. Policy responses to international Liquidity

Meaning of International Liquidity:

Background

The academic circles throughout the world have remained greatly concerned with the problem of international liquidity.

The problem is, by no means, of a recent origin. One of the basic factors for the breakdown of the gold standard in 1931 was the failure of the leading gold standard countries to cope effectively with the problem of international liquidity, which was created by the inadequacy of gold reserves with the debtor countries and those which had balance of payments deficit coupled with the reluctance to lend on the part of those which were strongly placed in the matter of international payments.

The pinch of the problem of inadequacy of gold and foreign exchange reserves was felt more particularly in the post-war period when the European countries launched programmes of rehabilitating and reconstructing their economies and the developing world initiated the programmes of economic development. The resultant balance of payment deficits of almost chronic character intensified the pressure of demand for the international exchange media.

The controversies about the evolution of an acceptable international system of payments became much more intense during 1950's and 1960's. No doubt, a system of Special Drawing Rights has been evolved by the IMF, yet the international economic world remains dissatisfied and the payment adjustments and availability of foreign exchange still remain as the unresolved problems.

Meaning

The term 'International Liquidity' means all the financial resources and facilities that are available to the monetary authorities of individual countries for financing the deficits in their international balance of payments when all other sources of supply of foreign funds prove insufficient to ensure a balance in international payments.

In the words of Brahamanand, "The term 'International liquidity' refers to the supply of certain categories of financial assets or claims which are created by all the different countries and international financial organisations in the international community, as receptacles of calculable ready purchasing power over all the domestic currencies in vogue".

The international liquidity may be distinguished from the domestic liquidity. While the latter includes, apart from money, the time deposits, postal savings, co-operative society deposits, treasury bills, short- term bonds, the former, which refers to the various ways by which the different countries can raise their ready purchasing power over the goods of other countries without initially affecting their own trade balance, includes the official reserves, namely gold held by the central banks and treasuries of different countries.

The international liquidity, however, does not include a great deal of the financing of the international trade, viz., the vast complex of private foreign exchange holdings and bank and trade credits. The credit supplied by the international institutions like the Export-Import Bank, the World Bank, International Finance Corporation and International Development Association for the specific purposes of trade too remain excluded from the international liquidity.

Form the point of view of an individual country, the international liquidity has the demand and supply aspects. The demand for international liquidity arises out of demand for imported goods and services, capital outflows and unilateral transfers.

The supply of liquidity concerns the sources of international liquidity.These sources include gold mines in the country, export receipts, capital inflows and unilateral transfers. An excess of demand over supply causes depletion or shortage of international liquidity reserves. On the opposite, an excess of supply over demand would make addition to international liquidity reserves of a given country.

The unconditional and conditional liquidity distinction

A distinction can be made between the unconditional and conditional liquidity. The unconditional international liquidity is constituted by a country's official gold stock, its holding of foreign currencies and SDR's, its net position in the IMF and private holding of international assets. In case of all such reserves, there are no conditions or restrictions upon the user's right to borrow.

The conditional international liquidity consists of borrowed funds of a country from other countries or international lending institutions. The lenders impose certain conditions or restrictions upon the use of funds by the borrowers. The conditions may be concerning specific projects or programmes, repayment provisions and specified economic policies. The purpose for enforcing these conditions is to prevent the misuse of liquidity by the borrowing country.

In the absence of sufficient amount of international liquidity required to maintain balance of payments equilibrium, the deflation of incomes or the retention of direct controls over trade and payments will have to be resorted to. In the present day world economy, committed fully to the pursuit of full employment and high rates of economic growth, restoration of payments equilibrium through deflationary policies is unimaginable.

Similarly, taking recourse to controls and provoking retaliation from other countries, may prove to be self-offsetting. A proper solution to this problem is to supply the international economy an adequate amount of liquidity. But, unfortunately, the total gold and foreign exchange reserves with the countries other than the United States have dwindled greatly during the post-war decades. It is the depletion of international reserves that has forced many countries to persist with direct controls over trade and payments.

Aspects of International Liquidity:

There are three main aspects of international liquidity:

1. Nature:

The outstanding external debts of a country may be settled in three different ways.

Firstly, the debts may be liquidated through the transfers of gold or of some currency, universally acceptable and convertible to the creditor country. Throughout the latter half of the 19th century, sterling which was convertible into gold served as a universally acceptable currency, and side by side with gold, it constituted an international reserve. Since 1930's, the U.S. dollar has come to assume the predominant role in the settlement of external deficits.

Any currency which is to serve satisfactorily as a reserve currency must satisfy according to W.M. Scammel the following conditions:

(i) It must be the currency of some great trading nation and one which may be earned easily through normal trade and whose balances carry the promise that these may be exchanged for goods both desirable in themselves and for the world demand which exists for them.

(ii) The currency must be relatively more stable than other currencies.

(iii) The currency must be supported in its home country by great and experienced banking institutions of skill and probity.

(iv) The currency must be free from recurrent scarcity.

No currency of the world strictly conforms to these criteria. In the words of Scammel, "These are exacting criteria for an international currency to conform to and it is doubtful if they were met precisely by sterling in its heyday, still less by the post-war dollar. But any currency which is a candidate for international usage must approximate to these criteria and the extent to which it conforms is likely to determine its success."

Secondly, the international payments may be made through what we may call the "accumulation facilities". In this method of debt settlement, a country accepts the payments of debts in the debtor's currency, allowing the proceeds to accumulate in the debtor country as bank deposits or short-term assets. This form of debt settlement is, however, limited by the extent to which foreign countries are prepared to accumulate the currency of the debtor country.

The main instance of it is the accumulation of sterling balances in England for the supply of war materials and services during the Second World War. Such accumulation can be liquidated in various ways. The holder of accumulations may use them to buy goods or services in the country where it has accumulated. These may be used by the holder-country in a third country, which may provide the facility of convertibility into another currency or into all currencies. Another alternative is that these may become permanently funded debts held in debtor country by the creditors.

Thirdly, international debts may be settled by drawing rights upon foreign currencies. These may be in the form of foreign loans to the debtor nation or in the form of outright gifts such as those made by the United States of America under the European Recovery Programme. These may also include the drawing rights upon the International Monetary Fund which is in essence nothing more than a pool of currencies to provide additional drawing rights for member nations and thus raise the world stock of international liquidity.

2. Size:

The consideration of the size of stock of international liquidity is very important, since it represents the resources whereby the existing exchange rate is maintained. The distinction must be made in this connection between the reserves which a country must hold for the purpose of dealing with balance of payments deficits, and the reserves required to sustain a high import surplus attendant upon the programme of economic development.

At present our main concern is with the payments difficulties. But still the necessity of international liquidity cannot be discussed in isolation of its requirements for development. A country which has reserves adequate only for alleviating payments difficulties, may find it difficult to cope with heavy demands of liquidity for financing economic development.

The aggregate world reserves of international liquidity necessary for smooth operation of the world payments are contingent upon the following three factors:

(i) The policies of leading economies, with regard to exchange rates are important. A larger world stock of international liquidity will be required under a regime of fixed exchange rates. In such a situation, even at equilibrium levels, more reserves will be required than in case of flexible exchange rates.

(ii) The policies of the leading economies with regard to the control of their levels of income and employment also help determine the optimum level of reserves. In a fully employed economy, the balance of payments deficit can be met through a deflation of income.

If the government in that country is committed to maintain a high level of income and employment, deficits must be met through drawings upon reserves. "As long as", says Scammel, "deflation as a means of balance adjustment is foresworn by the great economies, they must be prepared for recurrent calls upon national currency reserves and must accumulate reserves large enough to meet these."

(iii) The character of international trade— whether it is bilateral or multilateral, also influences the optimum size of international reserve holdings. If a mechanism of fully convertible currencies exists, the holding of a single national reserve of gold and currencies will be capable of liquidating liabilities in any country. If, on the opposite, the currencies are not convertible, a country must hold a reserve of the currency of every country (or group of countries), with which it trades and with whom it may incur a deficit.

Actually it is very difficult to estimate accurately the amount of international liquidity that a country commands. The published figures include only gold and foreign exchange in the hands of the monetary authority as the only known categories of reserves. It is not possible to assess accurately the quantum of reserves a country can draw upon in a situation of dire need.

For instance, when in the autumn of 1956 speculative pressure against sterling threatened the reserves, it was known that the British government could muster actual reserves greatly in excess of published figures of gold and dollars in the Exchange Equalization Account.

3. Distribution:

The world stock of international liquidity must be ideally distributed among the countries in relation to their needs, which can be determined by the degree of fluctuation to which a country's balance of payments is subject, the volume of its trade and the requirements of its development. The present state of distribution of liquidity is by no means ideal.

The underdeveloped world is in a dire need of liquidity both for the payments adjustments and economic development. But the resources available to them are utterly inadequate as compared with the excessive stocks of liquidity held by the more developed countries.

The problem of the inadequacy of international liquidity is evident from the increasing balance of payments difficulties and poverty of the individual countries. It also fully impresses the fact that the media of international payment—gold and foreign exchange reserves—have failed to grow at a rate fast enough to meet the growing demand for them. This has been reflected in a consistently low ratio of reserves to imports for the world as a whole since the early 1950's. On an average, this ratio has been around 31.5 percent during 1970's and 1980's. It reflects an overall liquidity shortage faced by the world community.

Although the international reserves (in SDR term) have expanded to a large extent from 46 billion dollars in 1949 to SDR 2170 billion in 2009, yet both the developed and under-developed countries have continued to feel their inadequacy.

The problem of international reserves has become so acute that even the leading countries of the world today are under excessive strain. The gravity of the situation can be judged from the fact that the balance of payments compulsions forced even the United States to devalue her currency twice within a short span of 14 months between December 1971 and March 1973.

Role of IMF in Enlarging International Liquidity:

There is no doubt that the willingness of advanced countries to reduce their trade surpluses is the real long-term and permanent solution to the problem of international liquidity shortage. But so long as equitable trade arrangements are not made, the satisfactory short-term solution has to be evolved.

Since the IMF has been the principal source of the supply of world liquidity, it has a very vital role in resolving this problem in a satisfactory manner. In order to augment the world liquidity resources, the IMF has adopted various measures from time to time.

(i) Increase in IMF Quotas:

With the object of facilitating greater availability of exchange reserves to the member countries, the IMF has raised the member countries' quota from time to time. Upto the close of 1988, there

had been eight revisions of IMF quota. The member countries' quota which was just 3.5 billion U.S. dollars originally, had raised upto 205 billion dollars or 145 billion SDR's by the end of 1993. In the Twelfth General Review of Quota in January 2003, the maximum quota of member country was raised to SDR 213.7 billion.

In 2009, the member countries' quota stood at SDR 217 billion, out of which India's share was SDR 4.16 billion. Out of it, about 21 percent was allocated only to the United States and 44 percent to five leading advanced nations. The access to international liquidity for the rest of the world was still inadequate.

(ii) Financial Accommodation:

The IMF attempts to meet the short-term credit requirements of the members for the adjustment of balance of payments deficits. The member countries can borrow upto 25 percent of their quota almost automatically without any constraint. It is called as gold tranche. In subsequent years, they can borrow 25 percent of their quota each time, called as credit tranche. Such drawings are subject to progressively higher interest rates along with certain other conditions. The repayments have to be made within three to five years.

(iii) **Raising of the Limit of Borrowing under Credit Tranche:**

The borrowing limit for the member nations under the credit tranche has been gradually raised over the years. At present the members can draw upto the equivalent of 450 percent of their new quotas on the total net use of Fund's resources. The limit of borrowing is to be reviewed every year. The raising of borrowing limit is a step in the right direction to relieve the shortage of international liquidity.

(iv**) Standby Arrangements:**

In 1952, the standby arrangements were introduced to permit member countries assurance of additional reserves in the event of need or emergency. England got the assistance under this arrangement in 1956 after Suez Crisis. The other countries too availed of these arrangements from time to time.

(v) **Swap Arrangements:**

The central banks of the Group of Ten (Group of 10 leading industrialized countries) entered into an agreement in earlier 1960's, under which they could exchange each-others' currencies and also provide short term credit to tide over their temporary balance of payments disequilibrium. Such an arrangement has the approval of the IMF but it is not directly under the purview of it. This arrangement is very limited and cannot help relieve the liquidity shortage faced by the countries other than those included in the privileged Group of ten.

(vi) **New Credit Facilities:**

With the object of relieving the international liquidity shortage, the IMF has been expanding credit facilities since 1960's. The new credit facilities instituted by it include Compensatory Financing Facility (CFF), Buffer Stock Financing Facility (BSFF), Extended Fund Facility (EFF), Supplementary Financing Facility (SFF), Oil Facility and Trust Fund.

(vii) Special Drawing Rights:

A revolutionary innovation made by IMF to tackle the problem of international liquidity has been the introduction of the scheme of Special Drawing Rights (SDR's) in early 1970's. This scheme is intended to create and issue the SDR's as unconditional reserve assets.

The IMF creates SDR's at regular intervals and allocates them to the member countries on the basis of each member's quota. For this purpose, the Fund keeps a Special Drawing Account. A country can have easy access to the reserves of any currency by agreement and the intermediation of IMF.

The transfer of reserves from one member to the other upto the limit of borrowing country's quota is facilitated through book entries in the Special Drawing Accounts of the borrowing and lending countries. In all these transactions, the IMF acts like a clearing house.

Initially the Fund created SDR 9.3 billion over the three years between 1970 and 1972, allocating them to 112 participants in the SDR scheme. In 1978, the Fund decided to raise them by SDR 4 billion in each of the years 1979, 1980 and 1981. In 2009, allocation of SDR's by the IMF among the member countries stood at SDR 217 billion.

Although IMF has acted as the principal source of international liquidity creation and distribution, and it has achieved also some measure of success, yet the problem of international liquidity is still far from being resolved. The surplus countries even at present are not willing to recognise that their accumulations of large exchange reserves are the root cause of the whole problem and the solution of the problem of inadequacy of international liquidity fundamentally rests in the reduction of their surpluses.

Unless they do recognize this fact and do reduce their surpluses, the LDC's cannot get rid of their deficits and the problem of international liquidity will continue to plague the international trade relations.

Policy responses to international liquidity

Policy responses to international liquidity call for a consistent framework that considers all phases of global liquidity cycles, countering both surges and shortages. Such a framework should rest on three lines of defence.

The first line of defence

The first line of defence is the prevention of excessive liquidity surges through strengthened regulatory frameworks. The current reform agenda clearly goes in the right direction. It will limit the probability and frequency of liquidity disruptions by increasing the resilience of global financial intermediation. It will also dampen the amplitude of global liquidity cycles by limiting the intrinsic procyclicality of our financial systems.

The second line of defence

Domestic policies are a second line of defence. They include, inter alia, macroprudential measures and central bank liquidity provision. One issue is the extent to which individual countries will want to insure themselves against liquidity shocks by building sufficiently large stocks of foreign reserves. The accumulation of reserves, which has been on an increasing trend, entails some negative externalities as well as operational challenges. The report notes, however, the complexity of drivers behind reserve accumulation, especially relating to the so-called precautionary motive. There are many factors at play: insuring against a run on domestic financial systems; providing foreign currency liquidity to domestic corporates and financial institutions; and

influencing market sentiment and risk premia. These same factors may also explain why there is a reluctance to use reserves in times of stress (the so-called fear of losing reserves). This raises the question of whether and to what extent other sources of foreign currency liquidity could substitute for the accumulation of precautionary reserves, thus helping to limit some of the costs and externalities imposed by large foreign exchange reserves holdings.

The third line of defence

Cooperative measures for the provision of liquidity in crisis situations provide the third line of defence. There is a well known tradeoff between ex ante clarity and the risk of moral hazard. Existing IMF precautionary facilities have worked well, but it is important to preserve the current level of conditionality. Swap arrangements between central banks have played a crucial role in the crisis, which has shown that truly global liquidity shocks necessitate direct interventions in amounts large enough to break downward liquidity spirals. Central banks' ability to elastically supply potentially very sizeable amounts of foreign currency liquidity at short notice can thus successfully assure credibility among financial market participants. This advantage has to be balanced, however, by the necessity of avoiding moral hazard, preserving monetary policy autonomy, and controlling financial risks for the liquidity-providing central bank.

Central banks have a key role to play in all these policy areas. The established cooperative Basel process ensures that central banks understand each others' reaction functions and economic outlooks. This provides the context within which they can set their own policies in a manner consistent with their domestic policy principles and financial and price stability objectives. Working through this process, central banks remain well placed to address future surges and shortages in global liquidity.

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