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*Raymond F. Mikesell*

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# Financing World Trade

Appraisal of the International Monetary  
System and of Proposals for Reform

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Crowell Economics Series

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*Raymond F. Mikesell*

UNIVERSITY OF OREGON

# Financing World Trade

An Appraisal of the  
International Monetary System  
and of Proposals for Reform

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# Preface

WRITING ON the international monetary system in 1967-1969 approaches financial journalism; important events relating to this subject have been occurring almost daily. Moreover, the immediate future promises no retardation of significant developments. However, I have endeavored to provide a framework for interpreting past and future changes in the institutions and policies that facilitate and influence international economic transactions.

In writing this book, I am especially indebted to Professor Henry N. Goldstein of the University of Oregon who nearly tore my first draft to pieces with his rigorous criticism (and might have done the same with this version had I permitted him to review it). I am also grateful to Dr. Howard S. Piquet, formerly of the Library of Congress, to Dr. Marshall D. Wattles of the University of Oregon, and to Drs. Philip P. Schaffner and John W. Tanner of the U.S. Treasury Department for their helpful comments; they are, however, in no way responsible for my errors of judgment or of fact. Finally, nothing of mine would be publishable save for the editorial labor of my wife, Irene.

Eugene, Oregon  
January 1969

R.F.M.

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# The International Payments Mechanism

## The Institutional Base

THE MODERN international payments mechanism must be viewed fundamentally in terms of institutional arrangements which have developed over several centuries. The pound sterling, during the nineteenth and twentieth centuries, and the dollar, after World War I, did not become universally accepted means of making international payments and achieve the status of international reserve assets merely because of their convertibility into gold, or because Britain and the United States adhered to certain principles of monetary management. They achieved preeminence because of the institutions which were created within these countries and because of the economic relationships of these countries with other countries. These institutions and institutional relationships include the banking systems, specialized financial intermediaries, the foreign exchange markets, a variety of short- and long-term capital markets, the trading relationships of Britain and the United States with the rest of the world, and the structure and pattern of their foreign investments.

The institutional basis for an international currency role is also related to the broad economic and political power of the country in question in world affairs. The currency of a minor power is an unlikely candidate for a key currency role. Thus, despite the prestige of the Swiss franc in terms of stability and soundness, based

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on a high ratio of gold reserves to the volume of domestic money and the political and economic stability of the country, the Swiss franc has not become an important international vehicle currency.<sup>1</sup> The growth of the British Empire during the eighteenth and nineteenth centuries laid the foundations for the pound sterling as an international currency, while the rapid emergence of the United States as a major world power and the leading creditor nation during and after World War I thrust the dollar into the predominant key currency position.

### *The Emergence of Sterling as a World Currency*

The essential elements in modern international payments are the financing of trade in goods and services and the transfer of capital assets between countries without the use of specie or direct barter. The basic instruments for the modern international payments system were developed on the European continent long before sterling became an international currency. The bill of exchange was introduced in Italy in the twelfth century, and the Bank of Amsterdam and the Amsterdam Bourse financed commercial transactions between countries in the sixteenth and seventeenth centuries before the Bank of England was founded in 1694.<sup>2</sup> The development of a market for internal bills of exchange in England during the eighteenth century, and the support of this market by the Bank of England when funds were scarce, laid the foundation for the London discount market which in the nineteenth century discounted bills of exchange arising out of trade among nations throughout the world.<sup>3</sup> Thus, exporters in foreign countries shipping to third countries began drawing bills not on the foreign importer but on a British merchant banking house, and these bills were drawn in sterling.

The predominance of sterling as an international payments me-

<sup>1</sup> The terms "key currency" and "vehicle currency" are applied to currencies used widely as a means of payment and for invoicing in international trade. "Wide use" implies use in financing of trade between countries other than the country whose currency is involved. The term "reserve currency" is used for currencies employed as international monetary reserves.

<sup>2</sup> See J. B. Condliffe, *The Commerce of Nations* (New York: W. W. Norton, 1950), p. 148.

<sup>3</sup> A bill of exchange is a draft drawn by an exporter on an importer or on a bank or financial institution to which the exporter looks for payment.



dium was enhanced by the expansion of Britain's trade and investment in its dependencies. Close financial ties between Britain and the economically less developed areas under British control—which included a large portion of the non-European world in the early part of the nineteenth century—assured that sterling would become the international payments medium of these countries and that their local currency reserves would take the form of sterling assets. Indeed, branches of London banks served as the principal banking institutions of the British dependencies, and London became both a source of loans and a depository of funds for a large part of the world outside Europe. The growth of British investments both on the European continent and in the non-British developing regions of the nineteenth century also furthered the international role of sterling.<sup>4</sup>

It is worth noting that the foundations for the world currency role of sterling evolved during the long period of suspension of specie payments (1797–1821) occasioned by the Napoleonic Wars, and that sterling continued to function as an international currency even during later periods of inconvertibility of sterling into gold or dollars at a fixed rate through much of the twentieth century, including the periods 1914–1925 and 1931–1959.<sup>5</sup> Moreover, the relationship between sterling and gold has been changed several times during the twentieth century, and sterling fluctuated freely without a gold parity between 1931 and 1939.

### *The Role of the U.S. Dollar*

The preeminent position of sterling as an international currency came to an end with World War I, concurrent with the emergence of the dollar as a rival world currency. Before 1914 the greater part

<sup>4</sup> See Herbert Feis, *Europe: The World's Banker 1870–1914* (New Haven: Yale University Press, 1930).

<sup>5</sup> Britain suspended gold convertibility of sterling at the beginning of World War I and sterling fluctuated in relationship to both gold and the dollar until the pound was stabilized in 1925. In 1931, the relationship between the pound and gold and gold convertible currencies was again broken and sterling fluctuated in relationship to the dollar and other currencies until the outbreak of World War II in 1939, when Britain adopted exchange controls limiting the convertibility of sterling by both residents and nonresidents. Except for a few weeks in 1947 nonresident convertibility of sterling was not fully restored until 1959.

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of U.S. trade was financed in London; even the trade between the United States and Latin America was financed by bills on London banks. Following World War I, the dollar developed as the dominant currency in world trade and finance, partly as a consequence of the establishment of the New York acceptance market and other financial institutions equipped to handle international transactions, and partly as a consequence of the large flow of dollar loans and investments to foreign countries. Among the currencies of the major powers, the dollar alone emerged from World War I as a strong and stable currency. The role of world banker shifted from Europe to the United States, which became the leading trader and financial power.

The growing importance of dollar financing in world trade led to a sharp rise in foreign holdings of short-term funds in the United States from about \$400 million in July 1921 to more than \$3 billion at the end of 1929.<sup>6</sup> This rise in the foreign holdings of dollar funds reflected in part the need for dollar balances to finance trade and to meet service obligations on U.S. foreign loans, and in part the increasing tendency of foreign countries to hold their official reserves in the form of dollars. As stated by the 1943 Department of Commerce study, *The United States in the World Economy*,

These holdings were largely connected with the development of the gold-exchange standard under which monetary reserves were held partly or wholly in the form of claims on gold-standard countries rather than in gold and which was widely encouraged in the early post-war years as a means of reducing the monetary demand for gold.<sup>7</sup>

During the worldwide depression of the 1930's, foreign short-term assets in the United States declined sharply but rose again to \$3.3 billion in 1939. After World War II they rose rapidly. By the end of 1967, foreign holdings of liquid dollar assets totaled \$33 billion, nearly half of which represented official reserves of foreign governments and central banks.<sup>8</sup>

<sup>6</sup> Hal B. Lary and Associates, *The United States in the World Economy* (Washington, D.C.: U.S. Department of Commerce, 1943), pp. 111-112.

<sup>7</sup> *Ibid.*, p. 115.

<sup>8</sup> Foreign liquid dollar assets include private dollar liabilities to foreigners with a maturity of less than one year plus foreign holdings of U.S. government obligations.

## The Role of the Key Currencies

A fundamental characteristic of the modern international payments system is the adoption by the world economic community of a few currencies which serve as the payments media for the vast bulk of international trade and capital transactions. These currencies are referred to as “key currencies,” or sometimes as international “reserve currencies,” or as “vehicle currencies.” These currencies came to be demanded for purposes of holding international liquidity in much the same way that domestic currencies are demanded for holding domestic liquidity. Each trading country could, of course, finance its trade with every other country with its own or perhaps the partner country’s currency, and in addition it could hold minimum working balances in the currencies of the countries with which it traded. Instead, however, countries prefer to finance the vast bulk of their international transactions with no more than two currencies and to hold a portion of their international liquid reserves in one or more of these currencies together with gold. The preference for employing only a few currencies in conducting international transactions has risen because of the institutional arrangements and relationships developed in the countries whose currencies have been selected. As has been noted, these include not only the institutions for financing current trade but also a variety of international capital markets which exist in the key currency countries.

It is more convenient and economical for countries to finance their international trade with one or two currencies rather than with many. For a time following World War II, much of the trade between countries outside the dollar area (mainly the United States, Canada, and northern Latin America) was conducted under bilateral payments agreements requiring trade between any two countries to be financed by the currency of one or the other trading partner. But this was an awkward system: first, because it required bilateral balancing of trade over time, and second, because it required the holding of larger operating balances than would have been needed if trade were conducted in only one or two currencies. Traders holding balances sufficient to balance income and expendi-

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ture streams in a number of currencies will require larger balances than they would if the separate income and expenditure streams were pooled by conducting all of their trade in one currency.<sup>9</sup>

Not only do traders require balances in the currencies employed in financing trade but, more importantly, the banks that handle the transactions of traders require inventories of these currencies. Since banks desire to minimize their inventories of noninterest-bearing balances, they may find it advantageous to hold interest-bearing assets in the countries whose currencies they have acquired but which they expect to need in the near future. This requires a well-developed money market in the country whose currency is held—something which exists only in the industrially advanced countries of the world. Moreover, there may at times be a net interest differential in favor of holding assets abroad after allowing for the cost of hedging against a decline in the value of the foreign currency. As will be discussed later on, a well-developed forward exchange market is important for reducing the cost of risk avoidance through hedging.

The principal currencies employed in international transactions provide a suitable international liquidity reserve for governments and central banks. Not only may reserves held in the form of foreign obligations earn interest, but the holders avoid the cost of converting foreign exchange into and out of gold which itself involves some cost to hold. Governments and central banks prefer to hold reserves in the form of marketable interest-bearing assets in countries with well-developed financial markets which provide a variety of maturities and interest rates, and which have ample depth and stability. Governments also often prefer to hold currency reserves in countries to which their residents, including the government, are heavily indebted, so that the currency of a large international lender country becomes attractive as a reserve currency. Finally, governments prefer to hold international liquidity reserves in countries whose currencies are expected to remain stable in rela-

<sup>9</sup> For a good discussion of this point see Alexander K. Swoboda, *The Euro-Dollar Market: An Interpretation*, Essays in International Finance, No. 64 (Princeton, N.J.: International Finance Section, Princeton University, February 1968), pp. 7-9.

tion to their own domestic currency. Stability in relation to the currency of the reserve asset holder is especially important to avoid an erosion of the domestic currency value of the reserve assets. Hence, countries have been known to be quite willing to hold reserves in a currency to which their own currency may be pegged as a consequence of close trading and financial ties, even though the reserve currency may be fluctuating in relation to third currencies.

The preferred currencies today are the dollar and the pound, and to a lesser extent the French franc by reason of France's close trading and financial ties with the former French dependencies that make up the French franc area. The currencies of some countries are frequently used in foreign transactions but only when those countries are involved in the transaction. Thus, the Canadian dollar is sometimes employed in certain transactions with the United States or with members of the sterling area; the Dutch guilder, the Belgian franc, and the Swedish kroner are sometimes used in transactions involving these countries as one of the trading partners. However, the degree to which a currency plays a key currency role is measured by the extent to which it is used in financing transactions between countries other than the key currency country itself. In this sense the dollar and the pound, in that order, are the predominant key currencies of the world.

The development of the key currency role, then, is partly a matter of historical accident, partly a matter of the development of the necessary institutional framework and worldwide trade and financial relationships, and partly a matter of the economic strength and the economic and political stability of the country concerned. All of these factors were important in the development of the pound and the dollar as key currencies. It should be emphasized, however, that economic strength and financial stability are not sufficient in themselves. For example, Germany is the second largest international trading country in the world and has a strong balance of payments and a high gold reserve ratio. Nevertheless, the Deutsche mark has not become a key currency, nor do other countries hold large official reserves in Deutsche marks. Indeed, Germany has not sought a key currency role, as evidenced by its restrictions on the payment of interest on nonresident balances and on

foreign holdings of fixed interest-bearing securities. Although there has been a marked decline in the use of sterling as a trading currency,<sup>10</sup> there is no evidence that sterling's place as the second most important international currency has been shifted to a third key currency. Nor is there evidence that the weakness in the U.S. balance of payments position during the 1960's has reduced the role of the dollar as a key currency. On the contrary, the growth of the Eurodollar market in financing international transactions and serving as a means of holding international liquidity indicates an enlargement of the international role of the dollar.

### *The Eurodollar Market*

The worldwide use of the U.S. dollar has been considerably expanded in recent years by the development of the Eurodollar market and by the practice of issuing bonds denominated in Eurodollars outside the United States. Eurodollars originate with a deposit of dollars in a European bank (frequently a European branch of an American bank). Usually the depositor receives a time deposit in dollars and the bank receives title to a dollar demand deposit in a U.S. bank. Once created, the typical Eurodollar dollar deposit goes through a chain of lending and redepositing. This process may be illustrated as follows:<sup>11</sup>

(1) The ABC Corporation of Europe transfers \$1 million which it has on deposit in a bank in the United States to the branch of an American bank in London. The deposit in the American branch constitutes a Eurodollar deposit. The deposit in the bank in the United States is now owned by the American branch in London.

(2) The London branch of the American bank redeposits the million dollars in the form of a time deposit with a bank in Belgium. This transfers ownership of the dollar deposit in the United States from the American branch bank to the Belgian bank. The original deposit is still a liability of the U.S. banking system, but now there are two European dollar liabilities—that of the London branch to the ABC Corporation and that of the Belgian bank to

<sup>10</sup> See Paul Einzig, "The Declining Use of Sterling as a Trading Currency," *Westminster Bank Review*, May 1968, pp. 2-10.

<sup>11</sup> Based on a similar illustration in *Euro-Dollar Financing* (New York: The Chase Manhattan Bank, 1968), pp. 13-15.

the London branch of the American bank—based on one deposit in the United States.

(3) The Belgian bank lends the dollars—i.e., the deposit in the United States—to a Belgian importer who makes a dollar payment to a Swiss exporter, who then purchases Eurobonds for his personal portfolio. The latter transaction shifts the deposit to a multinational company issuing the Eurobonds, which in turn deposits the proceeds temporarily as a Eurodollar deposit in an American branch bank in Paris.

(4) A bank in the United States borrows the dollars from the American branch bank in Paris.

There are several advantages in using Eurodollar deposits over direct dollar deposits in a U.S. bank. Foreign depositors can deal directly with their own bank rather than with an American bank. Eurodollar depositors may earn a higher interest in Europe than in the United States, and in many cases it is cheaper for a European to borrow Eurodollars in Europe where he is well known than it is for him to borrow dollars in the United States. The bank in which the Eurodollar deposits are made may lend the Eurodollars at interest or purchase securities with them; it may lend dollars or it may convert the dollars into another currency and lend that currency. It may even deposit Eurodollars with other banks that pay a rate of interest higher than that paid to its own depositors. It is estimated that some \$20 billion in Eurodollar deposits are in circulation outside the United States.<sup>12</sup>

U.S. commercial banks also borrow from the Eurodollar market, mainly through their overseas branches. As of June 1968, U.S. banks had liabilities to their overseas branches in excess of \$6 billion. Most of these funds represented Eurodollar deposits with the overseas branches of American banks.<sup>13</sup>

<sup>12</sup> For a description of the Eurodollar market see Oscar L. Altman, "Recent Developments in Foreign Markets for Dollars and Other Currencies," *IMF Staff Papers*, X (1963), 48–96; and "Eurodollars: Some Further Comments," *IMF Staff Papers*, XII (1965), 1–16; see also *Euro-Dollar Financing*, p. 25; and "Sustained Expansion in Eurodollar Banking," *Monthly Economic Letter* (New York: First National City Bank of New York, October 1968), pp. 116–119.

<sup>13</sup> See Fred H. Klopstock, "Euro-Dollars and the Liquidity and Reserve Management of United States Banks," *Monthly Review* (New York: Federal Reserve Bank of New York, July 1968), p. 130.

Eurodollars are also used in financing the flotation and purchase of dollar bonds issued overseas (Eurobonds). European and foreign firms operating in Europe find it desirable to issue securities in the European capital markets. American firms operating in Europe have been borrowing large amounts of funds in the European capital markets, especially since the imposition of restrictions by the U.S. government on capital outflow to Europe. Multinational firms generally prefer to borrow dollars because such funds are accepted throughout the world and can be used free of exchange or capital controls in conducting worldwide operations. At the same time, international investors prefer dollar-denominated bonds, and Eurobond financing in dollars has tended to be less expensive than borrowing in other currencies. While some Eurobonds have been denominated in Deutsche marks or in Swiss francs, Eurobond issues denominated in dollars accounted for 76 percent of all such issues in 1966 and 91 percent in 1967.<sup>14</sup> An estimated \$2 billion in bonds denominated in Eurodollars was issued in 1967, and a larger amount is expected to be issued in 1968.

## Financing Goods and Services

It is customary to divide international transactions into two categories: (1) the flow of goods and services and (2) capital transactions. The financing of goods and services gives rise to capital movements, but there are many capital transactions that are unrelated to the movement of goods and services. This is true, for example, of the purchase of securities by a resident of one country from a resident of another. Exports of goods and services may be financed in a variety of ways, and this financing may or may not involve a foreign exchange transaction. A foreign exchange transaction occurs when there is a transfer of a currency or a claim on a currency which is not the currency of one of the partners to the transfer. For example, a resident of the United States may transfer a dollar deposit to an Englishman in payment for imports from Britain, and the Englishman may transfer the dollar deposit to his

<sup>14</sup> *Euro-Dollar Financing*, p. 24.



bank in exchange for pounds. Thus, a foreign exchange transaction involves the transferring of purchasing power from one currency into another. (By "currency" we mean the national money as defined, usually demand deposits in banks plus legal tender currency.) A claim on a currency may take the form of a bill of exchange drawn on the buyer (or his bank)<sup>15</sup> by the seller and payable on presentation (sight), or the claim may be payable at a stated time in the future, say in three months.

Exports of goods and services that do not give rise in the first instance to a foreign exchange transaction include those made available under long-term credit arrangements, or as government grants or private gifts; goods sold under open account or on consignment; and exports of goods and services by a firm in one country to its branch or an affiliate in another country.<sup>16</sup> Such transactions do not have a *direct* effect on the foreign exchange market since the importer need not acquire the currency of the seller (or draw on his inventory of the seller's currency) or increase the supply of his own currency in the hands of a nonresident in case payment is made with the buyer's currency. However, long-term credit transactions, or even gifts in kind, may have an indirect effect on the foreign exchange market, since the credits (or gifts) may be used to import goods that would have otherwise been acquired by a foreign exchange transaction. Exports of goods and services by a

<sup>15</sup> A substantial amount of trade is financed by means of letters of credit issued by the bank of the importer (or by the foreign correspondent of the importer's bank). The letter of credit authorizes the exporter to draw drafts in his own or a foreign currency on the bank issuing the letter of credit. If the letter of credit calls for payment at some stated time in the future, the issuing bank writes "accepted" on the face of the draft drawn by the seller, and payment is made when the banker's acceptance comes due. Meanwhile, it may be sold in the acceptance market or held by the seller until it is due. The accepting bank will look to the foreign buyer or his bank for delivery of the currency called for by the letter of credit at the time the acceptance becomes due.

<sup>16</sup> Foreign aid in the form of loans or grants may also involve a foreign exchange transaction. The donor agency may make available funds (or guarantee a bank letter of credit) to the aid recipient which may be used for purchases of specific commodities or services or, in some cases, for any purpose. Thereafter, normal foreign exchange transactions may take place between the actual exporters and importers of the goods and services financed by the foreign aid.