National Center for Policy Analysis

BRIEF ANALYSIS
No. 280
For immediate release:
Wednesday, September 23, 1998

Foreign Dollar Holdings and the U.S. Money Supply

One of the most important of all economic indicators is the money supply. Most economists believe that it plays a major role in the level of interest rates, inflation and real growth in the economy. The Federal Reserve controls the money supply through various policy instruments.

- It can require banks to hold higher or lower percentages of its deposits as reserves that cannot be lent out.
- It can change the interest rate on funds that banks borrow directly from the Fed.
- It can buy U.S. Treasury securities on the open market, paying for them by creating money.

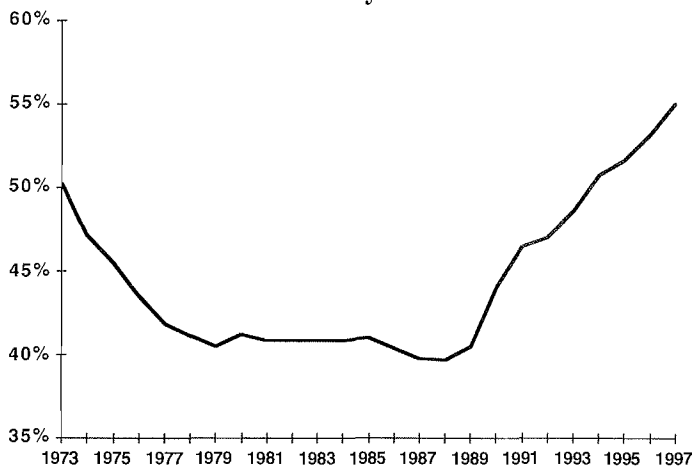
This last instrument, known as an open-market operation, is the primary means through which the Fed controls the money supply. In practice, the Fed targets the federal funds rate, the interest rate on funds that banks lend to each other on an overnight basis. Currently, the Fed target for the federal funds rate is 5.5 percent. When the market interest rate rises above this level, the Fed provides additional reserves by buying Treasury securities; when it falls, the Fed drains reserves by selling securities.

There are various measures of the nation's money supply.

- M1 is the sum of currency and demand deposits (checking accounts) and a few other items such as travelers' checks.
- M2 includes M1 plus small interest-bearing accounts (those under $100,000), including money market accounts.
- M3 includes M2 plus certain other large time deposits (those over $100,000).

FIGURE

Foreign Holdings of Dollars as a Share of Currency in Circulation



Source: Federal Reserve.

In all of these monetary measures, currency is a major component. According to the Federal Reserve, at the end of 1997 there was $425.5 billion of currency in circulation; M1 equaled $1,076 billion; M2 came to $4,045.8 billion; and M3 totalled $5,374.9 billion. More importantly, the annual increase in currency is often the main component of the increase in monetary measures. For example, between 1993 and 1994, the increase in currency accounted for more than 200 percent of the increase in M2, the most commonly used measure of the money supply.

The Mystery of the Missing Currency. Since currency is such an important component of the money supply, it obviously is very important to have an accurate measure of it. In practice, the Fed assumes that all the money ever printed is still in circulation, less only that which has been officially withdrawn from circulation or is known to have been destroyed. However, when the Fed has attempted to survey banks, businesses and households to find out how much currency was actually circulating, some 80 percent of the currency thought to be in circulation had simply disappeared.

Efforts to locate this missing money have focused particularly on "exports" of U.S. dollars: money that has left our shores and now circulates in foreign countries. For many years, there were no estimates of these exports. In the last two years the Federal Reserve has developed estimates of currency exports that it believes are reliable. The Commerce Department now publishes them in the *Survey of Current Business*, a monthly publication of the U.S. Government Printing Office. The table presents the data on both the stock of U.S. dollars circulating in foreign countries and the annual flows.

Of course these data can be criticized, but in all likelihood they represent a low-end estimate of foreign holdings of U.S. dollars. That is because they mainly

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measure legitimate currency flows going through the banking system. They exclude flows through other channels, such as tourists, personal remittances and overseas military bases. More importantly, they exclude flows through illegal activities such as drug dealing. Thus we can assume that at least this much U.S. currency circulates in foreign countries and is not part of the domestic money supply. The figure shows foreign holdings of dollars as a percentage of currency in circulation. As one can see, more than half of all U.S. currency now circulates outside the U.S.

What This Means. At a minimum, this suggests that the money supply is much lower than published data indicate. Economist Case Sprenkle of the University of Illinois argues: "Since foreign-held currency is not a medium of exchange for the issuing country, increases in currency in the hands of the public in developed countries then should not be considered as money supply increases for monetary policy decisions. The Federal Reserve and other central banks should ignore such increases as being basically irrelevant to domestic monetary conditions."

TABLE

Foreign Holdings of U.S. Currency
(millions of dollars)

Year	Net Flows	Foreign Holdings at Yearend
1973	n.a.	30,500
1974	1,100	31,600
1975	1,500	33,100
1976	1,500	34,600
1977	1,900	36,500
1978	3,000	39,500
1979	3,000	42,500
1980	4,500	47,500
1981	3,200	50,200
1982	4,000	54,200
1983	5,400	59,600
1984	4,100	63,700
1985	5,200	68,900
1986	4,100	68,900
1987	5.400	78,400
1988	5,800	84,200
1989	5,900	90,100
1990	18,800	108.900
1991	15,400	124,300
1992	13,400	137,700
1993	18,900	156,600
1994	23,400	180,000
1995	12,300	192,300
1996	17,362	209,662
1997	24,782	234,444

Source: *Survey of Current Business*, July 1997, p. 49; and July 1998, pp. 68-69, line 59.

This could have important implications for Federal Reserve policy and monetary analysis. It might mean that Fed policy is much tighter than the Fed thinks it is and that the historical relationship between growth of the money supply and rate of inflation needs to be reevaluated. It also could have important implications for foreign countries that do not currently count U.S. dollars as part of their money supplies. Since only minuscule amounts of foreign currencies circulate in the U.S., this is not much of a problem here. But in a country like Russia, dollars could be a very significant part of the money supply.

The foreign demand for dollars is likely to remain strong for the foreseeable future. The underground economies in foreign countries are rising rapidly and are heavily fueled by cash. U.S. $100 bills are often the currency of choice. Moreover, economic turbulence in Russia and Asia has increased the demand for dollars as a store of value and a medium of exchange. Since dollars are accepted everywhere and easily invested in a wide variety of financial instruments, they are clearly the safest and most convenient money for international use. In many respects, the dollar has replaced gold as the safe haven of choice.

Conclusion. Foreign holdings of U.S. dollars are a significant and growing phenomenon. They are now so large as to affect our basic understanding of the relationship between the money supply, inflation, interest rates and other economic variables. The phenomenon may be causing the Federal Reserve to run a tighter monetary policy than it intends, with important implications for economic growth, unemployment and the standard of living of all Americans.

This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett.