



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON D.C. 20551

DIVISION OF INTERNATIONAL FINANCE

November 14, 1991

The Honorable Charles E. Grassley
United States Senator
135 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Grassley:

Chairman Greenspan has requested that I answer the questions posed by Mr. Charles S. Sanders in the letter that you shared with us.

Mr. Sanders presents an interesting hypothetical that stimulates the reader to reflect on the fundamental nature of our international monetary system. Fortunately, it is not hard to conclude that even "suppos'n" some foreign government attempted to purchase large portfolios of foreign assets by printing money "to the Nth power," it could not succeed.

Let us first note, however, that there is a very clear explanation of the Japanese accumulation of U.S. and other foreign assets, and it is not Japanese money creation. Rather, it is the Japanese trade surpluses -- that over the past five years, for example, have totaled over 340 billion dollars. As is well understood, if any country runs a trade surplus (or more accurately, a current account surplus), it must accumulate some sort of foreign asset equal in dollars to the value of the original surplus. Thus, any time a country exports more in value than it imports, other countries owe the first country an amount equal to this trade surplus -- that is, the first country becomes a creditor nation and accumulates foreign assets. For Japan, its cumulative current account surplus since 1986 has required it to accumulate 340 billion more dollars in foreign assets. It is of course natural to expect the owners of these foreign assets to diversify their holdings -- holding some stocks and bonds and, in some cases, to purchase real assets such as hotels, farms, etc. Thus, contrary to Mr. Sanders' supposition in "Suppos'n," it is very much the case that the Japanese have "made enough honest money on Hondas, Toyotas, and computer chips" to buy up their existing share of U.S. real estate, capital, and enterprises.

Moreover, it is comforting to know that it would be impossible for any country to succeed in a strategy of printing money to buy up a sizeable stock foreign assets. In order for a country to exchange its currency for foreign assets, foreigners must be willing to hold the newly printed currency; but clearly no rational individual would want to hold the money of a country that was just running the printing presses to create an oversupply of worthless currency. As soon as the original, inflating country tried to purchase the foreign assets, the exchange rate

for its currency would plummet; this is to be expected, because no one would want to exchange their assets for a worthless currency. This is, in fact, what does happen to the currencies of countries that overinflate their money supplies; they do not accumulate sizeable portfolios of foreign assets, but rather run into a rapidly depreciating exchange rate and rampant inflation at home. It is not necessary to point out that this scenario does not apply to Japan.

Sincerely,

Guy V.G. Stevens
Senior Economist
Division of International Finance