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INTERNATIONAL MONETARY EVOLUTION

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at

Columbia University

New York City

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One piece of wisdom was left to posterity when the attempt to redesign a blueprint for the international monetary system was given up in 1974. The IMF's Committee of 20, that had labored for two years on the project, concluded that the international monetary system would continue to evolve. No truer word has been spoken on this seemingly immortal topic. The system certainly has been and is in continuing evolution. Some of its evolution has been along structural lines, changing the nature of its organization. Among present departures in this area are the work on a substitution account, the European Monetary System, and the effort to strengthen IMF surveillance. Drift toward a multicurrency reserve system could bring a further structural change. The recent upsurge in gold prices has revived suggestions, impractical in my view, for a new fixed price of that commodity.

Policies carried on within the international monetary system as it currently exists have also been evolving. There have been movements along various spectra of options. One such spectrum runs from fixed to

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to freely floating rates. Here, the initial move toward free floating has been in some degree reversed in the direction of more management. Within a second spectrum, running from preference for appreciation to preference for depreciation, a shift of preferences toward strength rather than weakness of national currencies has been observable. Finally, in the spectrum of options for dealing with payments deficits by adjustment or by financing, a move toward greater emphasis on adjustment may be ahead for many countries in this second round of OPEC-induced payments deficits. I would like to deal briefly with all of these elements of monetary evolution.

Substitution Account

The substitution account offers a means of reducing the international role of the dollar and enhancing that of the SDR. Nobody seems quite sure how much of a desire exists in the world for either move. For the United States, the reserve currency role has become a burden, in a world where the banking systems of foreign countries, as well as foreign branches of our own banks, can freely add to the world's supply of dollars. Some countries are reported to be diversifying some of their dollar holdings into other currencies. Thus a device like the substitution account which issues SDR-denominated claims against dollars placed in it could serve several national purposes, provided it can be negotiated.

For the United States, there are alternative options that limit the attractiveness to the United States of a substitution account. One such option is to continue with the existing system, which has advantages as well as burdens. The substitution account, therefore, must be view as an improvement for all countries, not only for the United States, if it is to be worth establishing.

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The big problem in designing the substitution account, numerous technicalities aside, is how to maintain the soundness of an account that has dollar assets and receives dollar interest to back SDR liabilities and pay an SDR rate of interest. These two stocks and flows are inversely related. If the dollar is stronger than the SDR in the exchange markets, interest rates prevailing in the United States are likely to be lower than the SDR interest rate, which is the average of the interest rates prevailing in the major currencies represented in the SDR. If the dollar is weaker than the SDR, dollar interest rates will tend to be higher than nondollar interest rates.

One option is to ignore possible divergences between the assets and liabilities and between receipts and expenditures. That, however, makes the future of the SDR liabilities issued by the account uncertain. It could become a well-backed asset with an adequate interest rate, or it could become the opposite. At the other extreme is the option of complete maintenance of value of the dollar (and perhaps other currency) assets of the account in terms of its SDR liabilities, together with a guarantee of the interest rate in SDR. If such arrangements were made and their burden were to fall entirely on the United States, the United States might as well forego the account and issue its own SDR obligations. If the entire burden were to fall on the foreign holders of SDRs, they would be no differently situated than if they continued to hold the original dollars contributed to the account. The logical arrangement would be a sharing of the burden, provided this were acceptable to the political authorities of the participating countries. This option would create a very attractive and highly liquid SDR instrument.

Still another possibility would be a maintenance-of-value guarantee for the dollars in the account (and perhaps other currencies as well) in case of dissolution of the account. Additional arrangements would then have to be

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made to cope with a possible interest flow gap. It is difficult to assess how attractive potential acquirers of the SDR instruments, other than the original depositors, would find such an arrangement. Another possibility that has been mentioned is to place IMF gold into the substitution account as a means of assuring maintenance of value and possibly of financing deficiencies in the flow of interest. The use of gold would have the advantage of providing a solution, though possibly only a partial one, to the risk of a capital and/or interest gap. In any event, the account, if negotiated, presumably would start with a moderate amount of assets and liabilities but would be expected to build up over time.

The European Monetary System (EMS)

The European Monetary System constitutes another direction of structural evolution, toward creating a zone of exchange-rate stability and incidentally limiting the role of the dollar in intervention by the participating countries. The system now has been in operation for about one year. Neither the hopes nor the fears associated with its creation seem to have been more than very partially validated so far. The system per se does not seem to have produced the greater discipline on its members that would have helped to bring down national rates of inflation. But neither can it be held responsible for the higher inflation now prevailing in countries where inflation was low, before the recent oil price increases, nor has it led to exaggerated exchange-rate rigidity or payments controls. Some of the smaller members may have felt that their currencies were pulled along excessively by the D-mark. Some also may have felt under a constraint

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to match German interest rates more than they would have wanted to for domestic purposes. That, of course, is what discipline means.

For the United States, the EMS has not had the result that some may have feared -- a coordinated European dollar policy aiming at control over the value of the dollar. It has had the anomalous effect of pulling up, relative to the dollar, the currencies of some countries whose rates of inflation were no less than those of the United States, at a time when the U.S. current account was improving. Since the EMS, under the terms of its charter, is to evolve in the direction of tighter cohesion, its effects may change over time.

IMF Surveillance

The IMF has the power, and indeed the obligation, to exercise surveillance over the exchange-rate policies of its members. The Fund has been given the power also to monitor the monetary and fiscal policies of its members, since these are important determinants of exchange rates. Finally, as a third perimeter of surveillance, the Fund can examine into members' policies with respect to the financing of their payments deficits. The surveillance process covers countries in surplus, influence over whose policies has always been a weak part of the adjustment mechanism. To implement the surveillance process, the United States has proposed that countries with large imbalances submit to the IMF proposals for dealing with them, that the Fund assess the performance of individual countries in a global context, that the Managing Director more often take the initiative in arranging consultations with members, and that the IMF examine how payments imbalances have been financed.

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The Fund has approached its task of surveillance with a great deal of caution. It is significant, however, that the United States has declared itself willing to accept this degree of IMF influence. Historically, the United States has been resistant to any thought of IMF influence over our freedom of domestic decision-making. One may view this evolution of U.S. thinking as evidence that the United States increasingly realizes that its domestic policies may benefit from balance-of-payments discipline, as well as finding greater activity of the IMF in this area in the U.S. interest generally.

A Multicurrency Reserve System

The drift toward a multicurrency reserve system is not an organized process. It seems to be happening, in some degree, as a result of diversification efforts on the part both of some central banks outside the G-10 group of countries and of some private sector participants. Such a move is not surprising under a system of floating rates. A diversified portfolio, whether of common stocks or of currencies, has less risk for a given rate of return than investment only in a single company or a single currency. In choosing the desired composition of their currency portfolio, holders presumably will give weight to the distribution of currencies in which they conduct their imports and in which their debts are denominated. That would still leave a very sizable demand for dollar assets. Indeed the share of the dollar in monetary authorities' portfolios of foreign exchange holdings since 1970 has been fairly constant at about 75 percent.

The world has had experience with multicurrency reserve systems before. Gold and silver, sterling and dollar, gold and dollar, with an admixture of French francs, have all been tried by force of circumstances

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and have been found to be unstable as holders switched from one asset to the other. A new edition of the old text probably would not turn out very differently. I might note additionally that the countries whose currencies are candidates for reserve-currency status seem to be far from enthusiastic about the prospect. This observation also suggests that the United States on balance has had more burden than benefit from the reserve-currency role of the dollar.

An alternative to a multicurrency reserve system would be an SDR-based system. An SDR-based system seems far preferable. To be sure, the lack of progress made by that instrument since its creation in 1969 might give one pause. One should think that, if the SDR was a promising financial instrument, the private market would have created and popularized its counterpart, the SDR claim. So far, very few borrowers outside those from the IMF have wanted to borrow in SDR, and few depositors have sought SDR deposits. A demand for such instruments, if it were manifested, could, of course, be accommodated by the private banking system as well as by other financial institutions.

The fact that the interest rate on the SDR has been kept artificially low is not a complete answer. It applies only to the SDR that is issued as a liability of the IMF. The potential role of SDR-denominated claims and liabilities is much wider. Borrowers and lenders could put on such instruments any interest rate commensurate with interest rates in the underlying basket or part thereof, or even an independent interest rate.

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Nor is it a valid explanation of the failure of the SDR claim to find customers so far that its rate of return, taking 100 percent of the computed interest and the appreciation or depreciation against particular currencies into account, has been less than the total return on the strongest currencies. *Ex post*, the same can be said about any successful common stock -- it has outperformed total return on an average portfolio. But that does not prevent most investors from preferring diversified to highly concentrated portfolios. In the exchange market, any currency may be expected so to position itself that its total return, interest plus expected appreciation, is equal to that of other currencies allowing for factors of convenience and political risk. *Ex post* it will undoubtedly turn out that some currencies appreciated or depreciated in ways not expected, making total returns unequal. An investor gifted with superior foresight could take advantage of this. But the average investor or monetary authority will be better off with the lower risk of a diversified portfolio, of which the SDR claim, and to a lesser extent the ECU, are prime instances.

A means of easing the transition to a multiple-currency reserve system and of avoiding the market effects of sales of dollars for other currencies is sometimes suggested. It consists in an arrangement whereby the monetary authorities of potential reserve-currency countries would make available their currencies to foreign monetary authorities against payment in dollars outside the exchange market. The same avoidance of market disturbance, but with less risk for the buyer and less exposure to reserve-currency status for the seller, could be achieved if a central bank in that situation were to issue SDR liabilities. So long as SDR claims are not

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widely acceptable among central banks, a central bank issuing such liabilities would probably have to stand ready to convert them back into dollars or into its own currency at the prevailing exchange rate. Eventually, SDR claims might move in official or private market channels much as bank liabilities denominated in national currencies do today. The risk for the issuing bank, which acquires dollars, would in any event be less if it issues SDR liabilities against these dollars than if it issues its own currency.

No Return to the Gold Standard

The rise in the price of gold has encouraged suggestions that the monetary problems of the world could be solved by putting gold back in the center of the picture, fixing its price (by committing to buy and sell at this price), and starting a new ballgame. The implausibility of these proposals is easily seen if one notes their consequences. Suppose a single country were to fix a price for gold. It is most unlikely that that price would be one at which the market neither wants to sell nor buy gold on balance. If the price is too low, the country will find itself selling out its gold reserves to the market. If the price is too high, the country will find itself acquiring large amounts of gold and pouring out liquidity. The experience of the gold pool of the 1960's, which after all operated in a world still accustomed to stability, is a faint foretaste of that situation. The experience of the United States during the 1930's is also indicative. Following the rise in the price of gold from $20.67 to $35.00 per ounce, U.S. gold holdings rose from 195 million ounces in January 1934 to 419 million ounces in January 1939, although some of the movement probably reflected war fears.

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If several countries were to fix the price of gold, they would then effectively have fixed their exchange rates against each other. We would be back in the Bretton Woods system, but with much higher rates of inflation, and greater variation of inflation rates. Exchange rates would quickly get out of line, and the gold pegs would be broken.

Such a result could be avoided only if countries were to subject their domestic policies to a severe discipline designed to keep their domestic price levels and their balance of payments in line with arbitrarily fixed exchange rates. That would mean the full discipline of the gold standard. Some of the proponents of a return to gold seem to desire the imposition of such discipline. Whether that kind of harsh discipline is desirable, or whether it would just make us repeat the experience of 1931-33, its achievement today seems altogether out of reach. For some countries, moreover, the discipline might work in reverse -- forcing them to inflate when they do not want to inflate.

The more likely consequence of the rise in the price of gold is a reduction in discipline, if gold-holding countries were to take advantage of their new-found wealth. Looser fiscal policies and monetary policies, and looser balance-of-payments behavior, could all be financed if present gold profits were mobilized by a write-up of gold assets. It will take some effort to prevent this from happening in particular circumstances.

Between Fixed and Freely Floating Rates

Since generalized floating began in March 1973, the degree of acceptance of free floating has varied from country to country and from time to time. To the extent that there ever was acceptance of perfectly

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clean floating, there clearly has been a movement away from that position. At the same time, however, there seems to have been some convergence of views internationally that exchange rates cannot be determined by fiat or market intervention, but must be left to the determination of fundamental factors such as the rate of inflation, the current account, capital movements, and the rate of interest. It is recognized, of course, that these fundamentals are in good part themselves determined by national policy actions.

The difficulty of controlling exchange-rate movements by intervention was demonstrated, for instance, in 1977, when foreign central banks bought approximately $35 billion without being able to prevent the decline of the dollar. Japan, over the period January 1979-January 1980, reduced its reserves by about $12 billion without preventing a substantial depreciation of the yen.

Nevertheless, in a minor key, market intervention has come to be recognized as a means of countering not only day-to-day disorder, but disorder also in a broader sense. The history of exchange-rate movements during the period of floating suggests that exchange rates often overshoot on the upside as well as on the downside. Whether this reflects simply speculative bubbles and bandwagon effects, or differences in the speed with which asset markets and goods markets clear, a case has been seen to exist for countering excessive market movements. For the United States, this has meant a shift in the preponderance of intervention in the principal exchange-rate relationship, the dollar/D-mark rate, from the Bundesbank to the Federal Reserve and Treasury. This has largely relieved the United States of the

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popular foreign charge of "benign neglect" of its balance of payments and its currency, undeserved as that comment was in the light of U.S. policies outside the exchange markets. Other countries, of course, have intervened in dollars for much larger amounts than the United States. But so long as these interventions are perceived as isolated episodes relating to the particular circumstances of those countries, the action seems to be interpreted as directed toward the country's own currency rather than toward influencing the dollar.

Appreciation Versus Depreciation

Much of Bretton Woods thinking about exchange-rate policy derived from a fear of competitive depreciation. If this fear ever prevailed during the period of generalized floating since 1973, it has proved to be superfluous. The much more general tendency among countries has been to aim at a strong currency.

Many factors have contributed to this. Nowadays, a country suffering from unemployment can deal with it by domestic expansion. It needs no recourse to exchange depreciation to promote employment by stimulating exports. A declining exchange rate, on the other hand, has been observed to contribute to inflation and also to reduce the scope for domestic expansionary measures that would create adverse exchange-rate expectations. Vicious cycles of inflation and depreciation have acquired an ominous reputation, while virtuous cycles of appreciation and lower inflation have seemed worthy of emulation.

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As regards the dollar, the case for strength has gained from its reserve-currency role. Weakness of the currency in which the world carries its reserves, in which it trades and invests, is bound to create uncertainty, instability, and a propensity to systemic changes. Not all currencies can rise at the same time, but during a period of worldwide inflation all countries can pursue domestic policies designed to strengthen their currency to their own and the common good.

Financing Versus Adjustment

When the first OPEC price increase hit the world and created the prospect of a period of enormous deficits, it was widely recognized that a universal effort to eliminate these deficits by internal contraction or depreciation would be futile and possibly disastrous. Now that OPEC-induced deficits are mounting again, the same issue reappears, but with different accents. Countries that relied heavily on financing their deficits instead of adjusting them away during the earlier round will find it preferable to lean the other way this time. Their debt burdens, and the limited capacity of banks to accumulate obligations of particular countries, makes this advisable. Thus, within the spectrum that runs from adjustment to financing of deficits for countries already heavily in debt the accent should shift in the direction of earlier adjustment and less financing. Given that the OPEC-imposed deficits in the aggregate cannot be reduced quickly, this would mean that countries that are able to finance their deficit would have to accept larger deficits.

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Conclusion

As we view the evolution of the international monetary system, we have reason to reject the allegation that the system is in the process of disintegration. It is true that fixed rates have come to an end, that we may be moving to a multiple-currency system and that the appearance of shifting trends, such as sketched in this talk, in lieu of stable rules of international financial behavior, may convey the impression of disintegration. But the system has produced on the whole good results. The first oil crisis has been weathered, trade has expanded, international capital flows have been enormous. The ultimate calamity -- worldwide trade restrictions and a freezing over of international payments as happened during the 1930's -- has been conspicuously avoided. We are now facing a new test, and its outcome will be determined more by avoidance of that ultimate calamity rather than by any particular shape of the world's monetary system toward which it may evolve.

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