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Remarks by

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

to the

HWWA-Institut fuer Wirtschaftsforschung

Hamburg, Germany

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Seven weeks ago, here in Hamburg, the Interim Committee of the International Monetary Fund met without making significant progress on the proposal for a substitution account. One of the main initiatives toward restructuring the international monetary system thus was postponed if not indefinitely suspended.

What Problem Was the Substitution Account Designed to Solve?

Since the project had been thoroughly prepared, this outcome was not the result of technical difficulties, even though such exist. It was the consequence, rather, of a lack of a sense of urgency and an absence of pressure, therefore, to reach agreement. Disagreement existed especially with respect to how the risks inherent in the account -- possible inadequacy of interest receipts to cover interest obligations and possible shortfall of the dollar assets in the account below its SDR liabilities -- should be met.

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In addition, the developing countries announced potential demands as a condition for agreeing to the use of the IMF's gold to bridge at least in part any potential interest and capital deficit in the account.

In a sense, the lack of urgency to move ahead with this reform of the international monetary system was a backhanded compliment to the dollar. Evidently, the world felt no immediate need to reduce the international role of the dollar, particularly not at a time when the rise in oil prices was placing an additional premium on the availability of international liquidity.

Whether the project will be reactivated is uncertain at this time. Technically it is undoubtedly possible. But if progress is to be made, it would have to rest on a more complete agreement concerning the purposes of a substitution account. There has always been some ambivalence between two views of the account: as a long-term structural improvement in the world monetary system, and as a conceivable means for bailing out the dollar from possible short-run difficulties. In the American way of thinking, the support of the proposal has always rested on its long-term role. It is not well designed to serve the purpose of dollar support in the short run, even if that purpose were regarded as desirable.

The substitution account's structural long-term role has to do with the choice, now before the world, of moving toward an SDR-based world monetary system in which the dollar would play a diminishing role, or a continued drift toward a multi-currency reserve system. A diminishing role for the dollar seems to be in line with the diminishing weight of the United States in the world economy. The role of reserve currency has shown itself to be

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burdensome, its benefits rather minor in an age of floating exchange rates and ready access to international reserves through world capital markets. Any change in the role of the dollar presumably would be a gradual and slow process. It is a process, however, that is carried by market forces and may, therefore, be only in part, perhaps in small part, subject to the policy discretion of the world's monetary authorities. What matters immediately is the direction. Is the process moving toward a gradual increase in the reserve role of the SDR, as provided in the amended statutes of the International Monetary Fund; or is it moving toward an increasing use of other currencies along with the dollar, such as the D-mark, the Swiss franc, and the yen? A decision to activate the substitution account would move the process in the direction of an SDR-based system, although the ultimate outcome might still be a different one. Failure to activate the substitution account does not necessarily imply that evolution will be away from the SDR. There are other means, besides a substitution account, of enhancing the role of the SDR. But the present trend undoubtedly has been toward a multi-currency reserve system and there are many reasons for believing that this trend will continue.

The Multi-Currency Reserve System

The main impulse toward a multi-currency reserve system comes from the fact that, in a world of floating exchange rates, diversification of international assets reduces risk. For a central bank, ownership of a diversified portfolio of foreign exchange means less risk than ownership of a dollar portfolio. The measure of risk is variability. The variability

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of a diversified portfolio, with respect to any currency that is floating, is bound to be less than the variability of any one floating currency including the dollar. The principle is the same as the diversification of an investment portfolio of common stocks. The risk of even the most promising single stock is higher than that of a diversified portfolio, and so is the risk of even the strongest single currency, making allowance for total return in that currency, as compared with other currencies, rather than appreciation expectations alone.

It is important to note that comparisons of investment results in different currencies must be based on this concept of total return. An exact equivalence of appreciation expectations, inflation, and interest rates no doubt will never be attained. But broadly speaking it can be assumed that in the long run exchange rate movements will tend to equal inflation differentials and that interest rates will also equal inflation differentials. Thus, expected appreciation of any currency will tend to be offset, in terms of its total investment return, by a lower interest rate. To point out that historically this has frequently not been the case does not invalidate the principle. The market's foresight is very imperfect. But it seems plausible that, at any particular time, the market seeks so to value currencies that their expected future movements plus interest produce an approximately equal total return in all currencies, perhaps with some allowance for political and other special risks.

Of course, this does not mean that all investors would tend to prefer the same kind of diversification among currencies, such as that provided by the SDR. The precise composition of a diversified portfolio

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will differ for different central banks and different private holders. In the case of a monetary authority, it will depend on the country's trade relations, and on the currencies in which its foreign debt, if any, is denominated. The SDR, for example, at its present 30 percent, may be giving the dollar a rather high weight, measured by the U.S. share of world trade. Measured in terms of the world's international debt, that proportion may be quite low. Moreover, the currencies in which trade is invoiced are not necessarily the currencies of the countries involved in that trade. Each country finds itself in a special position in these regards. Thus, there is a host of considerations to be taken into account in constituting an optimal portfolio for a country's reserves.

It is this possibility of tailoring foreign exchange portfolios to the needs and preferences of individual countries and other holders that may make such portfolios more attractive than an SDR portfolio. Moreover, ownership of SDR claims may deprive the holder of the opportunity, illusory though it may be, of trying to beat the market by timely switches among currencies.

Nevertheless, it is precisely such switches among currencies that constitute the most serious liability of a multi-currency reserve system. The world has had much experience and much grief from such systems in the past. Shifts between sterling and gold, sterling and dollars, dollars and gold have plagued the international monetary community even while the amounts that could or did move were relatively moderate, and even when fixed exchange rates limited some of the consequences of such shifts. Today, with large

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international reserves lodged in floating currencies, the potentially destabilizing effects of switches from one reserve currency into another could be ever greater. Diversification threatens to be destabilizing even while it is still a relatively incipient process. Once a degree of diversification commensurate to countries' preferences has been achieved, a condition which some bankers believe to have been almost reached, potential instability will nevertheless continue to be a threat. We have observed that exchange-rate movements of major currencies, during short periods of time, sometimes have exceeded significantly any correction required by underlying economic factors, only to be reversed in short order. This tendency to overshoot would be enhanced, in all probability, by a multi-currency reserve system.

The development of such a system seems all the more probable today because holders' apparent interest in diversification is being supported by a growing willingness of potential reserve currency candidates to have that role forced upon them. Not long ago, some of the major candidates seemed determined to avoid that role, recognizing the problems for stability both of domestic money and capital markets and to the international value of their currencies. More recently, concern over oil deficits seems to have created a greater willingness to tolerate and even encourage accumulation of assets denominated in certain national currencies, especially D-mark, Swiss franc and yen, in the hands of OPEC holders.

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SDR Claims and Their Issuers

It is quite conceivable, of course, that such balance-of-payments financing directly with OPEC surplus countries could be consummated in SDR instead of in national currencies. There is nothing to prevent central banks, given an appropriate legal framework, from issuing SDR liabilities. This would be an alternative means of moving the SDR to a greater role in the international financial system. It would be necessary, in that case, to give the SDR claims in question an interest rate and other features that would make them attractive and competitive with a diversified portfolio of currencies. This consideration leads me to examine the SDR and its present role, or lack of a role, in the international monetary system in somewhat greater depth.

It is indeed puzzling why the financial markets have not generated more activity than has occurred in the creation and use of SDR. One would assume that, if money could be made thereby, such efforts would already be under way, but they seem few and far between. Conceivably this goes back to the structure of the SDR issued by the IMF as contrasted with an SDR claim which any private party could issue as its own liability. The IMF's SDR in this regard reflects the definition of a camel -- a creature designed by a committee. Its liquidity is somewhat uncertain and must be supported by a designation procedure. It reflects many competing concerns of the membership of the IMF, rather than the desire to make it a competitive market instrument. Moreover, it is only lately that its interest rate has been raised to 80 percent of the interest rates of the five major currencies in the interest basket,

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from a previous 60 percent which, of course, discriminated severely against the SDR as an asset.

The SDR claim to be issued by the substitution account would presumably have the same currency basket and interest rate as its namesake, but somewhat different liquidity and liquidating provisions, reflecting the fact that it is an obligation of a special account in the IMF and not an obligation of the IMF itself. But in its case, too, the lack of complete competitiveness with alternative assets is evidenced by the need for elaborate arrangements for transfer and encashment.

None of these difficulties needs to inhibit a privately issued SDR claim or even one that central banks might issue. Such an instrument could document its general competitiveness by being sold in the money market in competition with other securities. In fact, if it could not be successfully sold at its face value, i.e., if its market value turned out to be less than the market value of the constituent currencies, that would be evidence that the market was skeptical of the instrument. On the other hand, there is no reason why an issuer might not be willing to accept a moderate discount on his SDR obligation from the value of the constituent currencies, because of the probable saving in terms of borrowing or underwriting costs compared with separate borrowings or bond issues in a number of different currencies.

These considerations would apply whether the SDR continues to represent a basket of 16 currencies with an interest rate based on only five currencies, or is reduced to the five currencies that furnish the interest rate, or whether some intermediate solution is adopted. Different

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SDR baskets have different implications with respect to prospects for appreciation, depending on the currencies included. Their expected total return should not differ significantly, however, because, as I noted before, differences in appreciation prospects are likely to be compensated by opposite differences in the interest rates of the basket currencies.

Thus, there should be room in the reserves of central banks for three types of SDR -- the SDR proper issued by the IMF, the SDR-denominated claim issued by a substitution account, and the SDR obligation issued by suitable official agencies in lieu of obligations in their own currencies. For private holders, SDR claims issued by private parties could also be readily available. Instruments issued by the Fund, the substitution account, and official agencies could presumably be made available to private holders by appropriate legal arrangements. Private ownership of SDRs would be helpful to central banks because they would then be able to dispose of SDR holdings to the market instead of only to other official agencies. Open market operations and foreign exchange market intervention in SDR would become possible. This possibility, although not likely to present itself in the near future, would raise the question of the proportion of exchange reserves that might be constituted in SDR and the broader question of the total volume of these exchange reserves.

The Need for Reserves

The appropriate volume of exchange reserves used to be debated intensively under the heading of "international liquidity." The topic has taken a back seat to the substitution account and other issues, but it cannot

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disappear from sight. There has never been agreement as to the appropriate volume of international liquidity. Concerns in this area have ranged from a fear that liquidity would become inadequate and lead to restrictive trade and payments policies, to the opposite extreme that excessive international liquidity would contribute to world inflation.

The substitution account would not affect the volume of international liquidity, except as over time the value of the outstanding SDRs might deviate from that of the underlying dollars or other currencies in an upward or downward direction. By reducing the risk of holding foreign assets, it might in the long run increase the demand for international liquidity on the part of central banks.

That concept of total liquidity, however, has become increasingly difficult to define, and so has the relation of the substitution account to liquidity. The international liquidity of central banks today consists of several quite heterogeneous components. Some are highly liquid, like dollar assets and reserve positions in the International Monetary Fund. Some are only conditionally liquid, such as first credit tranche drawing rights on the IMF and even more the upper tranche drawing rights. Some are liquid only in small amounts and at an unpredictable price, such as gold holdings, which, however, have come to constitute a growing proportion of reserves owing to the rise in the price of the metal. The international credit capacity of an economy constitutes another international resource, which does not make its appearance in reserves at all. This credit capacity, in turn, is generally regarded as depending in some degree on the availability

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of other forms of reserves. Finally, reserves can be looked at in gross or in net terms, to the extent that countries have official foreign liabilities.

At one time it was widely thought that a move to a floating exchange rate regime would greatly reduce the need for an demand for reserves. Apparently that has not been the case. On the contrary, the prevalence of large payments deficits due in part to the rising price of oil has generated additional reserve demands. So has the practice of international borrowing. Thanks to the Euromarkets, the holding of international reserves is not expensive. For countries that have debt outstanding in these markets, carrying reserves in the currency of that debt involves a cost of no more than the spread over LIBOR paid on the debt. This, incidentally, seems to be one of the reasons why borrowing countries are so insistent on borrowing at minimal spreads.

Under these conditions, when even the measurement of international liquidity becomes very difficult, the question whether there is too much or too little appears moot. Perhaps the best answer that can be given is that it depends very much on who owns the liquidity. The countries having the largest foreign exchange and certainly gold reserves have always appeared unlikely to spend their reserves. Their domestic demand management policies have appeared to be independent of the availability of reserves. The need for balance-of-payments adjustment because of shortages of reserves, and the ability to avoid such adjustments because of ample holdings, typically has been present in the case of developing countries and some of the smaller OECD countries which, perhaps for that reason, dispose of only a relatively modest volume of reserves. Nevertheless, exceptions to this generalization have become

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visible, for instance, in the case of the Federal Republic of Germany and of Japan, both of which recently have made very extensive use of their reserves to finance payments deficits. But since both countries have pursued strong anti-inflationary policies all along, one would hardly attribute their current anti-inflationary policies as being dictated by a loss of reserves.

While postponement or suspension of the substitution account, and the correspondingly stronger drift toward a multi-currency reserve system, do not directly affect the volume of international liquidity, they do affect the manner in which that liquidity, i.e., international reserves, is used. I noted earlier that a more widespread ownership of SDRs, extending to the private sector, would make possible foreign exchange intervention in SDR. That possibility seems to have been shifted to the more distant and uncertain future.

The SDR and Exchange Market Intervention

Foreign exchange intervention in SDR would constitute a significant improvement in the international monetary system. It would limit the undesirable effects arising from use of national currencies. One of these consequences is that, in defense of a weakening currency, other currencies may be sold that are also weakening. In the case of the dollar, it is, of course, a frequent event that countries holding dollars as reserves are selling these at a time when their currencies are falling against the dollar but while the dollar is also falling against third currencies. More troublesome is the case where a country sells dollars because its currency is falling against third currencies even though it is rising against the dollar. For some countries, especially

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the Federal Republic of Germany, the monetary consequences of heavy sales of D-mark in support of the dollar or other currencies can become troublesome.

Many of these problems could be reduced, if not altogether removed, if some part of foreign exchange market intervention could occur in SDR. Use of SDR in exchange market intervention would also facilitate a structural improvement in intervention techniques that, however, could also occur to some extent under present practices of intervention in national currencies. Foreign exchange market intervention today, in most countries, stands where monetary policy in the United States stood during the 1950's. At that time, the principal guidance for monetary policy came from the "tone and feel of the market." This gave much leeway to subjective judgments and very little to objective quantitative analysis. Moreover, it focused almost exclusively on interest rates, with very little attention given to money supply. It was price oriented, in other words, rather than quantity oriented.

Foreign exchange market intervention today operates in a similar form. It is almost wholly oriented toward price, i.e., exchange rates, and very little toward quantities, i.e., balance-of-payments flows. It seeks to influence price, although usually without seeking to counter fundamental factors, without there being much of a notion of what the right exchange rate is.

In the monetary policy field, emphasis in most countries and particularly in the United States has shifted away from price and toward quantity. Today, many central banks have money supply targets which they

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pursue while allowing interest rates to adjust in greater or lesser degree. This technique has turned out to be a better guide than judgments made about the appropriateness of interest rates which are exposed both to genuine error and to political pressure.

A similar development may well occur, over time, in the foreign exchange market. It would be very worthwhile exploring whether a greater emphasis on flows and less emphasis on rates would be desirable. Balance-of-payments projections are widespread today and usually convey at least a sense of the order of magnitudes. Thus, it should not be impossible to determine the level of desirable flows into and out of a particular currency, in accordance with its deficit or surplus position, and to intervene in order to finance these flows in whole or in part. This would mean feeding exchange into the market (or absorbing it) on a fairly steady day-by-day schedule, somewhat analogous in the domestic sphere to the pursuit of a stable money supply target implemented by the steady provision of reserves. Under such a regime, exchange rates perhaps would be less stable from day to day, but this would be mitigated since the stable supply of intervention funds could be modified at times of market turbulence. But exchange rates would probably remain closer to their equilibrium levels under this technique than under present practices.

The need for greater steadiness in the approach to exchange rates is illustrated by two recent movements of major currencies -- that of the dollar and of the yen. The dollar, over a period of three months, moved up on its trade-weighted rate by some 11.6 percent and then moved down by about

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the same percentage over the next three months. The movement reflected interest rates and could hardly have been avoided altogether. But it could have been smoothed by a technique of steady intervention. The yen, over a period of a year and a half, dropped from a peak against the dollar of 177 to a low of 261 and then moved back to its present price of approximately 220. One of the results of the initial dramatic decline has been a flooding of world markets with Japanese products that threaten to bring on trade restrictions in the recipient countries. Japan and the world would have been better served by a stabler intervention policy that would have offered a chance, although no certainty, of cutting off the peaks and troughs of these movements.

Intervention techniques aiming at stabilizing flows rather than exchange rates, as noted above, could be carried out even with the use of national currencies only, as at present. They would become easier and more manageable if SDR could be used. Use of SDR would open up a greater opportunity for the IMF to play its surveillance role in the area of exchange market intervention, given the Fund's natural affinity to the SDR. The opportunity to move in all these directions has been postponed by the failure to introduce the substitution account at the Hamburg meeting, but even without the substitution account similar possibilities remain open. That they are likely to be realized only in the distant future, if at all, does not require underlining.

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