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Remarks by

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

at a conference on

"The Management of Foreign Exchange Rates"

sponsored by the

International Herald Tribune

New York City

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Many economists have tried to make estimates of central banks' demands for foreign exchange reserves. The results seem to show that central bank behavior in this respect does not fall into a predictable pattern. Years ago this conclusion already was apparent to Fritz Machlup when in an article entitled "Mrs. Machlup's Wardrobe" he concluded that central banks' desire to hold reserves was governed by only one rule: "Like Samuel Gompers' labor unions, all that they wanted was 'more.'"

By the same token, very little of a quantitative sort can be said about the currency composition of such foreign exchange reserves as central banks may choose to hold. Nevertheless, some general considerations that central banks may be expected to have in mind can perhaps be specified. From these some indication can perhaps be derived about the degree of central banks'

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attachment to the dollar and the pressures operating on them to diversify out of the dollar. These considerations may also give hints, although little more, as to the probable behavior and motives of private holders of foreign exchange.

Some Reasons for Holding Dollars

One such guide is the pattern of payments expected to be made in different currencies. This pattern is determined, in the first instance, by the currency denomination in which trade is invoiced. At the present time, very roughly one-half of the world's trade is invoiced in dollars. Beyond that, however, a monetary authority needs to consider not only the denomination of its payments but also the currency in which the respective goods and services originate. Even though imports from country X may be invoiced in dollars, their price will go up if country X has a currency other than the dollar and that currency appreciates. U.S. exports represent only about 12 percent of world trade. However, some currencies are more or less tied to the dollar. The volume of exports from the dollar area, therefore, constitutes a higher percentage of world trade.

In addition, country X may have debts in foreign currencies. International borrowings are denominated in dollars to a degree far exceeding the share of the United States in world trade. The share of international indebtedness to banks denominated in dollars is estimated, very roughly, at two-thirds of total such international indebtedness. Of Eurobonds and foreign bonds, something like one-half of the total issued in the last six years was in dollars. Country X can reduce the exchange risk inherent in its foreign debt by covering as much as possible of it by reserves. However, this does not necessarily mean that if country X has dollar debts equal to

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or exceeding its reserves, it will be well advised to keep all of these reserves in dollars. If it has additional debt in other currencies, it could also reduce exchange risk by holding reserves in those currencies. In effect it can cover only a fraction of its exchange risk in each currency.

Monetary authorities trying to minimize their exchange risk will also have to take into account the currency or currencies in which their countries' exports are paid. When country X has a steady flow of receipts in particular currencies, the advantage of holding reserves in these currencies is reduced.

Finally, there is the fact that most switches between third currencies are made through the dollar. Instead of trading sterling directly for D-mark, a transactor is likely to go from one of these currencies into dollars and from dollars into the other currency. While this may not add much to the total demand for dollars it is a significant aspect of its international role.

Not All Currencies Are Available for Diversification

Given all these facts, there will be some approximate distribution of reserve holdings that minimizes foreign exchange risk. However, it may not be convenient or even possible to maintain international reserves in those proportions. Not all currencies lend themselves to ready investment of liquid balances. This was illustrated by the recent decision of the IMF to change the SDR recently from a basket of 16 currencies to one of five. The market structure, types of assets available, and definition of interest rates of most of the eleven excluded currencies were not well suited to the needs of an international unit. They probably would not readily lend

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themselves to the needs of investors trying to diversify beyond the major currencies. For all these reasons one would expect that the share of world trade of a reserve currency country would represent only a minimum indicator for monetary authorities wishing fully to diversify beyond the major currencies. The actual proportion of a reserve currency held in fully diversified portfolios would exceed the reserve country's share in world trade. That seems to apply already to the dollar, but it would also apply to reserve currencies like the D-mark, the yen, and the Swiss franc.

The rigidities of the financial markets of even some of the major countries tend to place a further limitation on the range and extent of diversification. Prohibitions on purchase of short-term securities, low volume and difficulty of turnaround in financial markets, and the risk of exchange controls all work in that direction. On the other hand, the existence of the Euromarkets allows investors in many cases to bypass restrictions imposed on national financial markets.

Portfolio Considerations

The foregoing remarks give some indication of the possibilities and limitations of reserve diversification, which apply in somewhat different degree to official and private holders. In order to take a somewhat broader view of the problem of diversification facing national liquid funds, I shall examine the situation facing the investor, abstracting from the concrete limitations he encounters. Given free choice, the investor has to select among currencies that are "strong" relative to his home currency, currencies that are "weak," and currencies of about the same strength as his own.

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Typically, he will find that interest rates are low in the strong currencies and high in the weak. On a covered basis, the return on all currencies will tend to be the same, at least measured at Euromarket interest rates.

Monetary authorities, of course, typically hold their reserves in uncovered form. But if they regard the forward discount or premium on a currency as a predictor of expected exchange-rate movements, the same equality of expected total returns in all currencies will still prevail. Interest-rate differentials will be offset by expected exchange-rate movements. This view of the matter is buttressed by the theoretical consideration that, in the long run, interest-rate differentials as well as exchange-rate movements should equal inflation differentials.

Of course, everybody knows that things never work out this way *ex post*. Forward rates are poor predictors, interest differentials vary cyclically, and purchasing power parity is rarely maintained in either the short or the long run. Nevertheless, in the absence of more profound insights into what makes exchange rates move, these are the indicators that investors have to work with. The question is how investors are likely to react to the inherent uncertainties.

The exchange-rate change component of the total return is uncertain, while the interest-rate component is not. A risk-averse investor trying to maximize total return, therefore, would probably not value the expected exchange-rate change in the same way he values the interest rate. If he expects appreciation, he will probably allow for the risk that the appreciation may be less than expected or turn into its opposite. That would make him less likely to move into a strong currency, even if total

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expected return unmodified by risk would make it profitable. If he anticipates depreciation, he will probably give extra weight to that possibility. This will restrain him in moving into a weak currency despite the high interest rate. He might feel most comfortable in a currency having about the same strength as his own since he is likely to believe that this "equal strength" will minimize fluctuations of the two currencies against each other. This other currency should offer him about the same interest rate as his own, with a low variance, and hence a total return not dependent on exchange-rate expectations.

Official Holders

What I have described here may apply more to the behavior of private than of official holders. Official holders, at least as they express themselves in annual central bank reports, do not seem to stress total return. They seem to stress the gain or loss on reserves resulting from exchange-rate movements, without clearly combining the interest-rate differential. For a central bank, the exchange-rate gain or loss appears in the balance sheet, and a loss may invite criticism. The effect of the interest differential, positive or negative, is buried in the income statement. Thus, there may be a tendency among central banks to prefer "strong" currencies even though the interest return is low.

A preference for strong currencies could in past periods at least be defended on grounds of favorable investment experience. Over a number of years, the D-mark, the yen, the Swiss franc probably have gone up against the dollar by more than implied in interest differentials and forward premia.

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To the investment analyst, this is not a compelling reason why such investment performance should be repeated in the future. Indeed, all that it means is that expectations were wrong and that currencies had not positioned themselves to reflect the levels to which they would eventually move. But favorable past performance nevertheless may weigh importantly in investment decisions.

Meanwhile, however, experience with strong currencies has become rather uneven. Following long periods of strength, the D-mark and the yen and also the Swiss franc have had spells of relative weakness. Even if long-term trends should work out favorably, the aura of assured steady appreciation has tended to fade. The advice to buy strong currencies under all circumstances, therefore, may be no more persuasive than the advice to buy growth stocks in the stock market under all circumstances.

The Demand for Dollars in Official Reserves

All this, of course, has a bearing on the demand for dollars. I see no change, in the foreseeable future, in the present system of floating. The degree of management may vary, but a return to fixed rates seems very unlikely. Accordingly, the diversification motive which has supported a shift away from the dollar in official and private international balances will continue to be operative.

But how close are we to "optimum" diversification? The share of dollars in central bank portfolios in 1979 stood at about 70 percent. Since this includes the large OECD countries and especially the reserve currency countries that have no easy alternative to the dollar, a more meaningful

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number would be the share of the dollar in central bank portfolios outside this group. In 1979 this proportion amounted to about 60 percent. The share in these portfolios of the D-mark is about 14 percent. The share of the yen is about 4 percent. The Swiss franc reportedly accounts for 3 percent.

Candidates for Reserve Currency Role

The prospect for continuing displacement of the dollar depends also, in some degree, on the willingness of substitute candidates to be available. Until not long ago, Germany and Switzerland declared themselves reluctant to let their currencies become reserve currencies, while Japan expressed neutrality. The reasons, given especially by the German and Swiss monetary authorities, concerned the potential for disruption of monetary, capital market, and foreign exchange policy through large international flows in their respective markets.

This attitude has undergone a change since the increase in oil prices beginning in 1979 and the attendant current account deficits in some of the countries named. Inflows of OPEC funds have been actively sought. Some of the remaining restraints on capital inflows have been reduced. These actions have been accompanied by efforts to direct official inflows into the least disruptive channels.

These events illustrate a problem inherent in the role of a reserve currency. Historically, the market has tended to select a currency for this role when the respective country did not need short-term inflows from abroad. The dollar became a reserve currency during the 1930's, when the United States had large balance-of-payments surpluses, and enhanced its role immediately after

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World War II. But the United States, although never unconcerned about its balance of payments, ultimately relied excessively on the reserve function of the dollar. Without the opportunity to pay for its foreign deficits in its own currency, the United States would scarcely have continued to run payments deficits throughout the 1960's. Reserve currency status undermined balance-of-payments discipline for the dollar as it had previously done for sterling. This tendency probably has been enhanced, at least in the case of the dollar, by a bias in the direction of exchange-rate movements, at least under the old fixed rate system, toward depreciation vis-a-vis the reserve currency.

The countries whose currencies today are moving increasingly into a reserve currency role have given ample evidence that they intend to keep their currencies strong. That is apparent from the excellent anti-inflationary record of Germany, Switzerland, and recently Japan. It is indeed one of the reasons why the market has singled out these currencies for a reserve currency role. Moreover, it is unlikely that the role of any of these three currencies should ever become as extensive as that of the dollar in its heyday. In all probability, these countries could not count on paying for sizable balance-of-payments deficits entirely in their own currencies as the United States did, although they could readily expect to see these deficits financed by automatic short-term capital inflows. Thus they seem well protected against possible debilitating effects of a reserve currency role. Nevertheless, they would have been in a stronger position if the growth of this role were associated with current account surpluses rather than deficits.

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The Outlook

What does all this mean for the future role of the dollar in the international monetary system? The considerations I have listed suggest that while there are reasons for diversification, there are also limits. The share of the United States in world trade, the share of countries that are pegged to the dollar, the share of world trade invoiced in dollars, the prevalence of international indebtedness denominated in dollars, the vehicle use of the dollar in switching among third currencies, and the risk aversion particularly among private holders focusing upon total return, all indicate a continued strong role for the dollar. This presupposes, of course, that the United States will maintain a reasonable record in the quality of its economic performance and economic management, particularly with regard to the rate of inflation. A country with a rate of inflation substantially in excess of that of most other countries will have a hard time maintaining its currency as a reserve currency. The painful process to which this leads has been observed in the case of sterling, through successive crises in the 1960's, arrangements to support sterling on the part of other central banks, and finally agreement to phase out the reserve currency role. I do not foresee anything of this sort for the dollar.

Recently, it seems that there have been some reflows into the dollar and into sterling, i.e., into the old reserve currencies. In the short run, I would not give very much attention to movements of this sort. These movements seem to indicate fears that under present conditions in the markets nominal interest rate differentials have come to play an important role. At times when there is considerable uncertainty about future exchange

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rates, one would expect that real interest-rate differentials would be more influential, since they take into account inflation differentials and, therefore, in a broad sense, expected exchange-rate movements. One possible conclusion that could be drawn from the seemingly growing emphasis on nominal interest-rate differentials is that uncertainty about exchange rates may have diminished, or at least that downside risk in currencies with high inflation rates and high interest rates has for the time being come to be perceived as smaller than before. For the currencies in the European Monetary System that condition of diminished uncertainty is clearly present, so long as central rates are expected to be maintained. As far as the dollar is concerned, those stressing interest rates will also have to note that the outlook for the current account in 1981 is quite strong and that, in contrast to many other countries, the United States is likely to have a surplus which historically has been important for the market's evaluation of the dollar.

These, however, are relatively short-term matters. For the longer term, the role of the dollar in the international monetary system will be determined principally by U.S. domestic policies. It is in the United States' own interest to pursue policies that will make the dollar attractive also to the rest of the world. From the more detailed analysis I have given about the role that the dollar plays in trade, international lending, and foreign exchange, it is evident that a reduction in the role of the dollar would require major adjustments for the rest of the world that would be costly and that are not likely to be made without good cause.

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Conclusion

This makes it desirable, as well as, in my view, probable, that the dollar will retain an important role in the international monetary system. Perhaps the day will come when the special drawing right (SDR) will move to the center of the stage, and I for one would regard that as progress, and also as beneficial to the United States. The reserve currency role of the dollar today probably is more of a burden than an advantage. But the practical implementation of a dominant role for the SDR has a long way to go, and in the meantime the dollar will be much needed in its current role.

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