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Remarks by

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

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Institut fuer Kapitalmarktforschung

Frankfurt, Germany

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The topic which has been assigned to me -- "The D-mark as an International Investment and Reserve Currency -- Consequences for the Capital Market: An American View" -- at first blush may seem liable to the charge of excessive specialization. Upon closer examination it turns out to have a broader applicability, at least among narrow financial specialists such as we probably are. I shall take advantage of the opportunity that the topic offers to examine the different routes by which the D-mark and the dollar arrived at their respective international roles, the implications for the dollar of the D-mark's growing reserve currency role, and, to the extent that I am able, the implications of this role for the D-mark.

The total volume of D-mark assets held by nonresidents of Germany, while not known with any precision, can nevertheless be estimated far more closely than the volume of dollar assets. In mid-1979, the Bundesbank estimated the total of D-mark assets held by foreigners at DM 185.3 billion,

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then equal to about 13 percent of German GNP and to 46 percent of current-account receipts. If the growth rate of roughly 20 percent per year of these assets has continued, they might amount to close to DM 250 billion by this time.

Dollar assets owned by non-U.S. residents at the present time may be estimated at a very rough order of magnitude of $600 billion. This amounts to roughly a quarter of U.S. GNP and almost twice the U.S. current-accounts receipts.

Roads to Reserve Currency Status

There are significant parallels as well as differences in the early history of the dollar and the D-mark as reserve currencies. It was during the later part of the interwar period that the dollar began to function as a reser investment, and trade currency. Full flowering came after World War II, in an environment of fixed exchange rates and of nearly total absence of viable competitors in these roles. Both circumstances, of course, contributed to the evolution of these roles. Fixed exchange rates meant that there seemed to be no need, from an investor's point of view, for currency diversification in portfolios. Absence of viable competitors meant much the same.

The D-mark acquired an international investment role during the late stages of the fixed exchange rate era. Both its investment and reserve currency roles gained ground substantially, however, during the period of floating. During this time, the desirability of diversification became increasingly obvious to private and official investors and helped advance these roles for the D-mark. So did, of course, the poor performance of the dollar in foreign exchange markets.

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For the dollar, development of a reserve and investment role went hand in hand with its preeminence as a trade currency. Not only U.S. trade, which particularly in the early postwar period was very modest relative to U.S. GNP, but trade among third countries was invoiced in dollars. The fact that many currencies, particularly of smaller and of developing countries, were inconvertible and hardly appear in international transactions at all was helpful to the dollar's role in this regard.

The D-mark, on the other hand, has not, or at least not yet, developed a strong trade role. It is used principally in German export and import trade, and even there not exclusively, with somewhat more than 80 percent of German exports and only 40-50 percent of German imports being invoiced in D-mark. This has important implications. The D-mark has not, or at least not yet, had the same opportunity that the dollar has had, to enhance its reserve-currency role through the payment of German imports in German currency. Furthermore, the D-mark has not had the opportunity that the dollar had at one time, during the regime of fixed rates, to enhance its reserve-currency role through a commitment of foreign countries to accept D-mark at a fixed rate. Both circumstances may have permanently slowed the development of a trade and reserve-currency role.

Today, of course, the dollar also no longer benefits from intervention obligations implied by a fixed-exchange-rate regime. Both dollar and D-mark, too, today are under the same international discipline. Excessive creation of assets in either currency will press upon the exchange rate of that currency and cause it to tend to depreciate. To be sure, even under the fixed-rate system, the dollar was not altogether devoid of balance-of-payments discipline, so long as gold could be withdrawn in

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exchange for undesired accumulations of dollars by foreign monetary authorities. But today, there is no such difference in "discipline" between the two reserve currencies.

One important aspect of the history of the reserve role of the two currencies is in the relative strength of each country's balance-of-payments position at the time these roles began. The dollar became a reserve currency at a time when the U.S. current account was generally strong. Capital outflows from the United States supplied the world with reserves. There was full confidence in the fundamental strength of the dollar. Subsequently, the dollar lost some of its strength because current-account surpluses increasingly failed to cover capital outflows. Still later, the current-account surplus itself largely disappeared. It was during this transition period that the United States seemed to derive an important benefit from being able to pay its bills in its own currency without immediate repercussions upon its exchange rate. Eventually, the reserve-currency role of the dollar became more of a burden than a benefit.

The D-mark's evolution has traced a similar trajectory, at least for the time being, over a shorter period. The world sought to force a reserve-currency role upon the D-mark, while the German current account was strong. To all appearances, German policy resisted this role. In 1979, the seemingly perpetual current-account surplus disappeared under the impact of rising oil and other imports. At that point, a reserve-currency role may have seemed more attractive than before because it promised capital imports that would finance the current-account deficit. But, from the point of view of the potential holders, the D-mark's attraction did not increase. As a

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result, it became more difficult to implement a reserve-currency role than it would have been some years previous. As the United States knows from its own experience, the role of a reserve-currency country in deficit is harder to sustain than when there is a surplus.

But there is a difference between the American and German experiences. For the United States, the weakening of the dollar can, to some extent, be traced back directly to its reserve-currency role. The reduction in balance-of-payments discipline and other factors, which I shall discuss in a moment, have undermined the dollar. For the Federal Republic, the recent weakening of the D-mark in the foreign-exchange markets can hardly be seen as a result of its incipient reserve-currency role. Rather, the weakening of the D-mark has been a motive for government measures, which -- even if intended otherwise -- have intensified the reserve-currency role of the D-mark.

There is still another difference in the evolution of dollar and D-mark as reserve currencies. German monetary authorities, especially the Bundesbank, seem to have been much more cognizant of the economic implications of reserve-currency status than have their U.S. counterparts. The implications of foreign creation and ownership of D-mark assets, for the value of the D-mark and for German monetary policy, seem to have been well analyzed and understood early in the game. In the United States, the reserve-currency role of the dollar, and the power of foreigners to create dollar assets by creating dollar liabilities has received only limited attention and probably only limited understanding. This difference in German and U.S. attitudes reflects in part, of course, the potentially greater importance of these developments for a smaller and more open

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economy, with a monetary policy that must be highly sensitive to foreign-exchange markets and domestic and international capital flows.

Consequences for Monetary Policy

The monetary-policy consequences of a reserve-currency role while differing in degree of impact are in principle the same for the D-mark and the dollar. They are of three kinds: (1) shifts into and out of the reserve currency by private and official foreign holders, which affect the exchange rate unless offset by exchange-market intervention, in which case, unless sterilized, they affect bank reserves and money supply; (2) shifts by foreign holders among assets denominated in the reserve currency, such as between short- and long-term securities; and (3) the creation of financial instruments denominated in the reserve currency, such as domestic or Euro deposits or bonds, issued by domestic or foreign obligors, especially governments, and offered to domestic or foreign investors. These newly created assets, seeking acceptance in portfolios, press upon interest rates and exchange rates unless the rise in supply happens to be offset by a simultaneous rise in demand.

Each of these three operations affects the Federal Republic and the United States somewhat differently. In the foreign-exchange market, the world's demand for reserve-currency assets confronts, in the case of the United States, a supply derived from an economy with a GNP of over two trillion dollars and total financial assets that could be estimated close to 10 trillion dollars. In the case of the D-mark, the world's demand for assets confronts a supply emanating from an economy with a GNP of DM 1.5 trillion (1980) and financial assets perhaps of the order of magnitude of DM 2-5 trillion.

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Evidently there is scope here for a greater impact on the D-mark exchange rate than on the dollar rate.

In the money and capital markets, the same proportions apply. In German markets, moreover, the range of available asset types is more limited, partly because of restrictions imposed by the authorities, partly because of the paucity of Treasury bills and negotiable CDs. The United States has had the further advantage that the Federal Reserve routinely engages in open-market operations running into the billions of dollars. The effects on bank reserves of exchange-market intervention thus can easily be offset by open-market operations. In the United States, moreover, there is a market for short-term instruments among nonbanks, allowing the central bank directly to influence nonbank money holdings. This is not the case, at least to the same extent, in the Federal Republic.

All this implies that the reserve-currency role is potentially more disturbing for the Bundesbank than for the Federal Reserve. Accordingly, the Bundesbank has been very conscious of these possibilities and has tried to limit them by a variety of restraints on foreign ownership of domestic D-mark assets, capital-market controls, and the like (although most of this apparatus has been dismantled recently). The Federal Reserve has not had to be concerned about the domestic monetary policy consequences of exchange-market intervention. Neither has it had to be greatly concerned about foreign holders' shifts among assets within the U.S. capital market, such as the sometimes massive shifts by foreign central banks into or out of Treasury bills in consequence of their own foreign-exchange-market intervention.

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At most, the effect has been to distort slightly the customary relation of the Treasury bill rate to other short-term rates. For the Bundesbank, the repercussions of international flows and shifts among assets domestically could well pose more severe problems.

Reserve Currency Asset Creation by Foreigners

Both the dollar and the D-mark are affected by creation of dollar and D-mark denominated assets in the Euromarkets, be they in the form of CDs and other bank liabilities or of bonds and private placements. In the United States, this proliferation of Eurodollar assets and liabilities has received little attention and its impacts have been largely ignored, except for the so far unavailing efforts, undertaken in 1978, to subject Eurocurrencies to reserve requirements. The Bundesbank appears to have analyzed and understood the implications, for the D-mark exchange rate, of D-mark creation in third markets, as indicated by the measures it has taken to maintain some degree of influence over them.

Fundamental to an understanding of the effect of Euro-asset creation in any particular currency is the realization that use of a reserve currency as a unit of account and as a medium of exchange and store of value are very different matters. The value of the dollar and the D-mark would not be affected if foreigners were to measure their own economic magnitudes in terms of dollars or D-mark, any more than if they were to measure weights in terms of pounds instead of kilograms. But when a bank in London issues CDs denominated in dollars or D-mark, or if it underwrites and markets bonds so denominated, the case changes. If investors are to increase the proportion

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of such dollar or D-mark assets in their portfolios, the assets will have to be offered on more attractive terms, that is, at lower exchange rates and higher interest rates. Given the state of demand, an increase in supply ordinarily must lower price.

Such pressure on exchange and interest rates must be expected from an increase in supply of assets in a particular currency, relative to demand, whether these assets add to the liquidity of the market or not. If the assets are of a liquid sort, however, for instance short-term CDs, their creation also adds to the money supply in that currency. But when such monetary assets are created in a domestic market, the respective central bank can be expected to take them into account by limiting other forms of money creation and so avoiding a deviation from its money-supply target. When these assets are created in the Euromarket, however, central banks until recently have tended to ignore them, apparently on the assumption that they should not be counted as part of the money supply in their currency. The Federal Reserve since January 1980, however, has taken Eurodollars owned by U.S. resident nonbanks into account as part of its broad liquidity measures. The Bundesbank, however, does not treat Euro D-mark holdings of German resident nonbanks, which in any event are small, as part of the German money supply.

Even when the assets in question have only a very low degree of monetariness, e.g., long-term bonds, do they form a part of credit creation in the currency in which they are denominated. An accelerated rate of credit creation in its own currency, even if in nonmonetary form, should, of course, be of concern to a central bank. The effects, to be sure, are likely to come

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more from the action of the borrower in spending the proceeds, than from those of the lender who has put his incremental assets into a relatively illiquid form. In any event, the central bank can counteract any credit expansion that it may consider excessive by raising the level of interest rates. This would restrain borrowing in its currency, both in the domestic and in the Euro market, would slow down somewhat the rate of growth of its money supply as well as the issuance of new bonds, and so keep the overall expansion within desired limits. Such action would also offset the downward pressure on its exchange rate that otherwise would result from an increase in assets, liquid or nonliquid, in its currency.

Some economists question whether an increase in dollar or D-mark bonds issued by private borrowers (economists call them "inside assets") would affect exchange rates, on the grounds that the increase in assets is necessarily matched by an equal increase in liabilities. The greater supply of dollar assets is matched ultimately, over time, by a greater demand for such assets when the borrower must acquire dollars in order to repay his debt. But this offset may be far distant in time. The increase in the borrower's liabilities and his eventual actions to meet them are not likely to offset the immediate exchange-rate pressure resulting from their creation, any more than they are to offset the interest-rate pressure.

World financial markets have made extensive use of their power to create liquid and nonliquid dollar assets and some use also of their analogous power to create D-mark assets. It has not occurred to those concerned with monetary and foreign-exchange-rate policy in the United States to question the legitimacy of this use of the dollar any more than

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they would have questioned the use of the dollar as a unit of account to measure the value of assets and transactions by other countries. Nevertheless, as already noted, there is a difference between using a currency as a unit of account and as a means of payment or store of value. The latter has exchange-rate and interest-rate effects. If a foreign borrower were to issue currency denominated in dollars and looking like dollar bills, even though clearly marked as liabilities of that borrower and not of the United States, the impropriety of such a procedure would be universally perceived. The consequences of other forms of dollar creation have gone largely unperceived.

This has not been the case, however, with the creation of D-mark assets in the form of D-mark CDs and D-mark bonds. The Bundesbank has been traditionally concerned with such activities and has tried to keep them under control. In particular, the Bundesbank has objected to the creation of D-mark CDs by non-German issuers if they were to be sold to non-German investors, i.e., to the use of the D-mark in third-country credit transactions. It has likewise insisted that D-mark bonds of non-German obligors be issued only if a German bank were to participate in the operation as syndicate leader. Thus the Bundesbank has tried to exert some degree of control over the creation of D-mark assets and liabilities among non-German investors and borrowers. While participation as syndicate leader on the part of a German bank may not be an absolute form of control, it nevertheless gives the Bundesbank information and an avenue for exerting an influence. When the requirement for a leading role by a German bank is combined, as it has been recently, with a gentlemen's agreement temporarily impeding sizable medium- and long-term foreign lending by German banks, the degree of influence is virtually complete.

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I must confess to a certain sympathy for the Bundesbank's intention to control the creation of assets in D-mark, no matter where and by whom it takes place. A central bank should have a degree of influence over such asset creation. As I have already said, interest-rate policy can give it such control, since interest rates on domestic and Euro assets in a given currency are closely linked in the absence of capital controls. But this means, of course, that domestic borrowers in the domestic market may have to pay higher interest rates in order to implement restraint over the creation of assets in the international market. The dollar very likely has been exposed to exchange-rate pressures because of its heavy use in the creation of assets abroad. On the other hand, if the United States had implemented restraints over dollar asset creation by foreigners, perhaps in the form employed by the Bundesbank, the flow of international capital would have been less free and less productive than it has been. Moreover, an element of cartelization would have been introduced into international finance by limiting the composition of international issuing groups.

Common U.S. and German Concerns

In the light of this analysis, it seems clear that the United States and the Federal Republic have basically similar concerns with respect to the Euromarkets. Assets in dollars and in D-marks are created by these markets, both liquid and nonliquid. This affects prices, interest rates and exchange rates. Thus there continues to exist, in my view, a common interest in establishing a degree of control over dollar and D-mark creation in the

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Euromarkets, without thereby necessarily implying that such control must take the form of reserve requirements. Appropriate interest rates, leading to appropriate rates of growth in money supply and nonliquid assets in the combined domestic and Euro sectors of the dollar and DM markets, will also do the job. Given the competitive superiority of the Euromarkets and their correspondingly more rapid growth, however, restraint exerted over the combined market through interest rates will hit domestic borrowers more severely than Euro borrowers.

I would like to conclude with comments on the effect that the evolution of the D-mark toward a more complete reserve currency status may be expected to have for the dollar. In this regard, I start with the assumption that various recent events and measures relating to that role, such as the recent weakness of the D-mark, the measures limiting capital outflows, and limiting the role of foreign banks, will not have a lasting effect on that evolution. That this is a reasonable assumption seems to be suggested by the experience of the yen, which also passed through a period of weakness and which, of course, has been far more exposed to administrative controls over international movements of capital.

Diversification out of dollars into D-mark no doubt has exerted some pressure upon the dollar and, to the extent that it continues, may do so hereafter. Diversification is a shift in demand for one currency as against another. Use of the D-mark for denomination of newly created assets, both syndicated bank loans and bond issues, on the other hand, would create relief for the dollar. Just as the proliferation of dollar assets through non-U.S. resident lenders and borrowers has exerted pressure on the dollar,

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creation of fewer dollar and more D-mark assets is likely to shift this pressure from the dollar to the D-mark. I see some benefit for the exchange rate of the dollar, therefore, from this aspect of the growth of the D-mark's reserve and investment currency role.

At the same time, I feel compelled to speculate whether in the area of investment in nonliquid assets, as contrasted with the holding of liquid short-term balances, both dollar and D-mark may not be affected by the competitive power of the SDR. SDR-denominated securities provide built-in diversification for the investor. To be sure, it has often been argued that for holders of liquid balances, the SDR has little attraction because these holders have no particular reason to accept the particular diversification offered by the SDR. They may prefer baskets more suited to their individual risk situation such as the currency structure of their debt, the currency composition of their receipts, and that of their payments. The case of long-term investors, however, seems different.

Investments rarely are held to meet particular obligations or to hedge against particular receipts, expenditures, and commitments in different currencies. Risk diversification _per se_ may play a greater role in the thinking of investors than of holders of liquid balances. In that case, the objections raised against the SDR as a form of diversification may have less validity for them. This suggests that the outlook for growing use of the SDR for denomination of long-term investments may be stronger than for liquid balances.

Such highly tentative speculations presuppose, of course, that international financial flows, both short-term and long-term, will remain as free as they have been in the past. The enormous importance of preserving this

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freedom, in a world of vast international flows of credit and debt service, is obvious. The main threat of this freedom, it seems to me, derives from high and unpredictable rates of inflation in many countries. It is by successfully combatting inflation, therefore, rather than by technical devices that the future of the international financial system must be secured.

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