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DARWINISM AND INTERNATIONAL MONETARY REFORM

Remarks by

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

at the

Twenty First Annual Bankers Forum
Georgetown University

Washington, D.C.

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The title of my talk refers, of course, to the decision taken by the Committee of Twenty to guide the process of international monetary reform in an evolutionary direction. No reference is intended to the survival of the fittest, except perhaps with regard to the intensive travel, working sessions, and food consumption necessitated by the meetings of the CXX and their Deputies.

The Fund and Bank meeting which most of you have attended has approved the work of the CXX. Some of the governors expressed a desire to go beyond the "Immediate Steps" proposed by the CXX and to continue toward a long-term reform of the international monetary system which the CXX has enshrined in Part I of its report entitled, "The Reformed System." But there were many speeches also in which support for something more structured than the present system of floating was at best moderate and occasionally completely absent. Most of the addresses made clear that the problem of oil has displaced monetary reform as the chief concern of finance ministers and central bankers.

*--The views expressed are my own and not necessarily those of the Members of the Board or its Staff.

That attitude is undoubtedly realistic. In my talk here I shall try to show, however, that there can be no neat separation between the two sets of problems. What happens to oil, to the balances of payments of oil-importing countries, to oil-associated capital flows, to exchange rates, and to trade patterns and practices will decisively influence the structure of the international monetary system, especially such features as exchange rates, exchange reserves, and trade and payments practices.

Oil Trade and Capital Flows

Let me review the elements of the oil problem. On the one side there are oil-exporting countries, which can increase their imports only gradually and which therefore are bound to have, as a group, a very large export surplus. On the other side are the oil-importing countries. They can reduce their oil imports by conservation and by creation of substitute sources of oil and other forms of energy. Nevertheless, as a group they are bound to have a very large current account deficit, which for 1974 has been estimated in the approximate range of \$50-60 billion. What remains uncertain and to some extent subject to policy decisions is the distribution of this deficit among importing countries, the distribution among them of the capital flows coming directly from the oil-exporting countries, and the distribution of the risk associated with the enormous volume of assets and liabilities that will be built up from these flows.

At the present time, some countries have both an oil deficit and a non-oil deficit. (The oil deficit is more correctly defined as their "incremental oil deficit," i.e., that part of the oil deficit that arises from the higher price of oil. This concept will become increasingly difficult to quantify in dollar terms as time goes on since we do not know what might have happened in the absence of the oil price increase. But it serves to clarify the principle involved.) Other countries, therefore, have by definition apart from their oil deficit, a non-oil surplus. Germany, for instance, has a non-oil surplus exceeding its oil deficit, hence an overall trade surplus. The U.S. also has a large non-oil surplus, but its still larger oil deficit has so far in 1974 made for a small overall trade deficit.

Given that the surplus of the oil-exporting countries and hence the combined deficit of the importing countries cannot be reduced below some minimum level, changes in the deficit of any one importing country can occur only if they are accompanied by an offsetting change in the deficit or surplus of another oil-importing country. By appropriate policies, such as domestic contraction or expansion, exchange rate changes, restriction of imports or promotion of exports, countries can shift their deficits to other oil-importing countries or accept some part of the deficit of others. Several principles for the most desirable allocation of deficits have been suggested as follows:

- (1) One proposal suggests that oil-importing countries should eliminate their non-oil deficits. If all countries with non-oil deficits do this, they will thereby eliminate also the non-oil surpluses of the remaining countries. This policy would reflect something like what is

often called, "putting one's house in order." It would aim to reduce the need to finance deficits, to the amount required to finance oil deficits.

(2) A second proposal asks each country to reduce its combined oil and non-oil deficit to the amount for which it can find financing in the capital market. Under present conditions, this would mean that some countries might not only have to eliminate their non-oil deficits, but achieve a non-oil surplus sufficient to reduce the oil deficit to a level capable of being financed. Other countries then would be forced to accept non-oil deficits on top of their oil deficits. These other countries could be presumed to be able to find financing for their deficits, since if the OPEC money is not flowing to the countries that have to cut their deficits, it must be flowing to those whose deficits are increasing. Put differently, this proposal says that if recycling proves difficult, i.e., if the money cannot be made to go where the current account deficits are, the deficits should be made to go where the money is. That would imply acceptance of large deficits by the countries that happen to attract most of the OPEC money.

(3) A third proposal is that the big countries should accept bigger deficits, even though their trade may not be large relative to their GNP. In that case, deficits would be distributed in proportion to GNP.

(4) A fourth proposal suggests that the economically weakest countries should be allowed to postpone paying for the oil in real resources, so as to soften the shock of their economies, while the stronger economies accept the real burden of the higher cost of oil

immediately. This would mean that the weaker countries would run large deficits, that would somehow have to be financed, while the stronger countries would eliminate their oil and non-oil deficits and thus bear the full transfer burden.

If economic imagination has run riot in dealing with the allocation of deficits, it is not surprising that ambitious ideas have been expounded also with regard to their financing. In the aggregate, the amount that the oil-exporting countries must invest in the importing countries in some form, liquid, illiquid, financial, or real, arithmetically must equal their aggregate surplus. But the term "recycling," which is often applied to the process by which the importing countries borrow back the funds they have paid to the oil-exporting countries in order to pay them over again for more oil, seems to take the ability of individual countries to obtain such financing too much for granted. The OPEC funds can flow into international markets, such as the Eurodollar market, into international institutions, such as the IMF and IBRD, and into national financial markets. It is worth noting that, under today's conditions of floating rates, "capital inflows" into a national economy need not affect the local money supply nor the level of interest rates. They will instead drive up the exchange rate and possibly alter the structure of interest rates if the flows go predominantly into some particular assets. This confronts the countries receiving funds in excess of their trade deficits

with a choice. They can facilitate an equivalent outflow, through interest rate policy or in other ways, or they can accept upward pressure on their currencies. Countries that receive or borrow less than the amount of their deficit, must adjust their balance of payments by depreciation, import restrictions and so forth. Failure of trade deficits and capital inflows to match thus creates problems both for those who receive more and those who receive less than they require.

Finally, the distribution of risk must be considered. To the extent that OPEC funds are recycled rather than moving directly into the countries using them, the ultimate investment risk falls, not upon the OPEC investor, but upon the recycler. This could be a bank, an international institution, a government, or in a broad sense, a national economy. The OPEC countries, in making their investment decisions, naturally will seek to minimize risk, in addition to maximizing other investment gains. Even if governments were not inclined to supply some sort of risk guarantee to OPEC investments, these investors can, by purchasing the obligations of a government in the open market, obtain the equivalent of such a guarantee if they desire it.

Evolution

The foregoing examination of the problems created by the high price of oil makes clear that the evolution of the international monetary system anticipated by the CXX will in fact be dominated by the evolution of the oil situation, where at an earlier stage it had been reasonable to expect monetary evolution to take place against a background of cyclical fluctuations of the type that had occurred since World War II. That expectation today is no longer valid. This will be true even if the price of oil comes down substantially. Such a decline would convert a problem that may be altogether unmanageable into one that could be managed with sufficient effort, skill, and foresight. It would not cause the problem to go away.

The surveillance of the adjustment process by the Interim Committee (later the Council) of the IMF, as proposed by the CXX, would probably be the principal means of crystalizing experience into system.

One important lesson that will have to be distilled from the experience ahead relates to countries' preferences with respect to exchange rates. I have outlined above various ways in which the financial pressures emanating from oil may impact upon exchange rates. Governments, of course, have options, with respect to rates, financing, and trade policy. As their preferences become apparent, hopefully in a cooperative process of mutual accommodation and support,

the feasibility and advisability of moving toward the long-term exchange rate objective of the CXX -- stable but adjustable rates with floating . . . in particular situations -- should become apparent. The same applies to the concept of zones for exchange rates written into the guidelines for floating. Its feasibility and advisability might be tested well ahead of the longer run goal. For the time being, it seems clear that floating rates are an essential protection against the massive imbalances resulting from oil payments and capital flows.

The demand for international reserves is another feature of the system that will have to evolve from future experience. The CXX anticipated, with varying degrees of agreement, that countries would establish norms for their reserve levels and would gradually move their actual reserves toward those levels. Exchange rate movements and other adjustment measures were to be guided, in some not fully settled degree, by the behavior of international reserves.

The oil situation is bound to affect the demand for reserves. The uncertainties which that situation creates are likely to raise the demand for reserves. These same uncertainties, however, are likely also to increase reliance upon floating rates which in turn diminish the need for reserves. There is some evidence showing that the use of reserves has actually increased during the period of floating, as compared with earlier years. This does not mean, however, that more

reserves are needed with floating than with fixed rates. It does mean that during the period of floating imbalances were so large that despite the reserve-economizing effects of the float, the desire to intervene and limit the range of fluctuations has grown.

We should also bear in mind that it would not necessarily be wise to increase the supply of international reserves to match whatever the increase in demand may turn out to be. Not only exchange rate variability, but also inflation has been much higher than anticipated. The difficult process of halting inflation could be hampered by an excessive creation of international reserves, whether in the form of SDRs, Fund quotas, or other credit facilities.

The demand for international reserves, as it evolves in the context of the oil problem, will contribute to defining the future role of different reserve assets in the system. The CXX agreed in principle that the SDR should become the principal reserve asset, with the role of gold and currencies being reduced. The SDR is indeed well on its way to becoming the principal numeraire, i.e., unit of account, of the international monetary system. That, however, does not make it the principal reserve asset. Only a new supply of SDR issues sufficient to meet the demand for reserves would do that, and there seems to be no present prospect of any issues on that scale. Gold has reacquired indirectly some usefulness as an international reserve asset, by becoming useable as collateral for international loans at a market

related price. But with respect to both SDRs and gold, it must be noted that their present usefulness as an international means of payment seems to apply only to transactions among oil-importing countries. The principal deficits of these countries, however, are not with each other, but with the oil-exporting countries. So long as the oil-exporting countries seek to acquire principally foreign currencies and investments in currencies, the role of currencies among reserve assets, especially the dollar, will be increasing rather than diminishing.

The payments and investment practices that will evolve with respect to oil and oil proceeds will also contribute to define the future role of currencies in the international monetary system, especially that of the dollar. The decisions of the CXX had reflected the desire on the part of many countries for a greater degree of symmetry in international financial relations. Symmetry implied that the role of the dollar, at least as a reserve asset, should resemble the role of other currencies and accordingly should be greatly reduced if not altogether eliminated. The oil situation has created new asymmetries in the world economy. With the exception of a few countries, the world has been divided into oil exporters and oil importers. The size and absorptive capacity of national capital markets has been given an importance that it did not have in the past. In light of this, the future role of the dollar in the international monetary system may well proceed in directions not anticipated by the CXX.

None of this means that the work of the CXX has been in vain, or that their long-term blueprint should be scrapped. In fact, the urgency of protecting the world monetary system against prospective pressures has increased. But a new and very large problem has moved into the foreground. The future of the monetary system will depend very much on how this problem is dealt with.