FOR RELEASE ON DELIVERY
THURSDAY, MARCH 6, 1975
8:00 P.M. FRANKFURT TIME

NEW OPPORTUNITIES FOR THE INTERNATIONAL MONETARY SYSTEM

Remarks by

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

at

Amerika Haus Frankfurt

in

Frankfurt, Germany

Thursday, March 6, 1975

FOR RELEASE ON DELIVERY
THURSDAY, MARCH 6, 1975
8:00 P.M. FRANKFURT TIME

NEW OPPORTUNITIES FOR THE INTERNATIONAL MONETARY SYSTEM

Remarks by

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

at

Amerika Haus Frankfurt

in

Frankfurt, Germany

Thursday, March 6, 1975

I am glad to have this opportunity to speak before the Amerika Haus of Frankfurt about the international monetary system. We are being made aware almost daily of the functioning of the system, by the news from the exchange markets. Floating rates have had good and less good results. A brief review seems appropriate before examining the evolution of the world monetary system in a broader framework.

Floating Rates

In a period of severe balance-of-payments disturbances, caused by worldwide inflation, the oil situation, countries' own specific problems, and other factors, floating exchange rates probably have been the only means by which frequent foreign exchange crises could have been avoided. During this very difficult period, international trade and investment has nevertheless prospered, and particularly the Eurodollar market has done a big job in recycling OPEC money. Floating rates have also provided somewhat greater freedom in the management of domestic policy. But there have been a number of painful side effects, in particular some very wide fluctuations in exchange rates.

Now the floating rate system is about to undergo a new test -- that of worldwide recession. Until not long ago, the system operated in an environment of worldwide boom and inflation. One of the significant experiences derived from that period has been that even countries with large current account deficits did not use exchange rate flexibility as a means of lowering their exchange rates. Concern over inflation, the ease of exporting and the relative ease also of financing payments deficits, seemed to make it advisable to keep exchange rates up. Only events can tell us hereafter how floating rates will function in a new environment.

Where Should the Deficits Go?

Another significant part of the international monetary picture has been the behavior of balances of payments, especially their current account. For the oil-importing world as a whole, the surplus of the oil-exporting countries provides a measure of the unavoidable aggregate current account deficit. It is no longer appropriate to think of this in terms of an "oil deficit." The original oil deficit resulting from the rise in oil prices has been modified, in a downward direction, by an increase in OPEC imports, by oil conservation, by the prospects for new production outside the OPEC area, and, in an upward direction, by mounting OPEC investment income. But it is still true that the current account surplus of the OPEC determines the current account deficit of the oil-importing countries.

Individual countries among the importers can, of course, reduce their current account deficit or even achieve balance or a surplus. Among the larger countries, Germany, Japan, and, to a lesser extent, the United States, have avoided sharing, or in the case of the United States, sharing very substantially in the aggregate deficit of the oil-importing countries which in 1974 probably was of the order of $60 billion. Correspondingly, other countries have shared very heavily.

One can apply differing criteria to what might be considered the optimal allocation of the unavoidable over-all deficit. Economics tells us that capital should go where it is most productive. Therefore those countries should have the deficits and finance them with capital imports that can make the most productive use of the money. But in saying this economics still does not tell us very much.

One way of looking at the matter is to ask which countries can least afford, in terms of their standard of living and other conditions, to pay for their oil through exports. It would follow that these countries should be given an opportunity to postpone the real transfer of resources by borrowing. According to this criterion, the countries that are running surpluses or only small deficits are helping other countries by taking on a larger share of the resource cost of paying for OPEC oil. This presupposes, of course, that the countries with large deficits can find financing, through recycling or directly from OPEC.

But financing may well become the main problem, at least for some countries. In that case a better key to the distribution of the over-all deficit would be a move toward lower deficits on the part of those countries that cannot easily find financing. An opposite adjustment would be appropriate for those that can finance or have reserves. If these latter countries should also turn out to be important recipients of OPEC investment funds, the possibly difficult choice between recycling these funds or allowing their exchange rates to go up would be eased for them.

Balance-of-Payments Management

Balance-of-payments management can draw on many techniques. The industrial countries have been reasonably successful in avoiding some of the less desirable techniques, such as trade controls. Capital controls continue in many countries and have been intensified here and there, sometimes with the objective of limiting inflows. The United States last year suspended the capital outflow controls that had been instituted during the early 1960's to protect the dollar.

Balance-of-payments management through exchange rate adjustment, which is the market-oriented alternative to direct controls, curiously has also been largely absent. For reasons that I have already examined, countries with severe current account imbalances have preferred not to let rates move flexibly. In some cases, this has required massive official intervention, or its equivalent in exchange markets.

Guidelines for intervention are an important part of the "Interim Steps" toward international monetary reform formulated by the Committee of Twenty and recommended by the Executive Directors of the International Monetary Fund. The relationship, therefore, between the "guidelines for floating" of the IMF and current exchange market intervention activity deserves to be examined.

The "guidelines for floating" require member countries to maintain orderly markets by day-to-day and week-to-week intervention. They also allow countries to establish target zones or for exchange rates and for reserves. Countries have engaged in a considerable amount of activity of the first kind, relating to maintenance of orderly markets. Standards have changed somewhat in this regard since the days of fixed rates, with daily rate movements on the order of one per cent no longer an extreme rarity. But markets have continued to clear transactions and generally have functioned well under this system.

Target zones for rates or reserves, which would have to be established in consultation with the IMF, so far have not been proposed by any country. Some countries, however, have operated in the exchange market in a manner not altogether different from what might be implied by operation under a target zone regime.

Official borrowing, from the Eurodollar market, from the IMF, from OPEC, and from other sources, has been one of the means of making this kind of intervention policy possible. Given the magnitude of international capital flows today, intervention may have to be on a very large scale in the absence of restrictions on capital flows. The amounts required for effective intervention also are likely to vary with the state of the markets. If opinions concerning exchange rates are firmly held, the amounts that can move in response to such opinions are enormous and small-scale intervention is likely to be swamped. When the market is uncertain in its views, a show of the intervening agency's intention may suffice to generate a self-sustaining movement in the direction desired by the authorities. It is well understood that intervention should not and cannot be used with any hope of success against widely recognized fundamental trends. In the long run, it is these fundamentals, today especially the rate of inflation, that are likely to prevail. The "guidelines for floating" must be read with these considerations in mind.

Somewhere between day-to-day fluctuations and fundamental trends are movements in exchange rates that may reflect temporary factors. Such might be a difference in the intensity or, as has frequently occurred, a difference in the phase, of the international business cycle. The old Bretton Woods system would not have viewed such cyclical imbalances as justifying an exchange rate alteration, so long as they could be expected to be reversed. Countries were expected to use their exchange reserves, including drawings on the IMF, and if necessary activate domestic instruments of monetary and fiscal policy in order to bridge such a period.

Under a system of floating rates, the problem has not disappeared, as we can see today. We have moved to floating rates, however, among other reasons precisely because it has become recognized that greater freedom is needed for domestic monetary and fiscal policy than was possible under the Bretton Woods system in the conditions prevailing in the late 1960's and early 1970's. Thus, the use of reserves for intervention would seem to be the principal means of avoiding cyclical exchange rate fluctuations, except as the countries involved may find it in their interest to prevent major exchange rate movements by appropriate monetary policies.

Under the old fixed rate system, while there still existed confidence in those rates, private market participants would have helped the authorities by engaging in stabilizing speculation. Today, the same possibility exists of benefiting from the strength or weakness of the currency that is believed to be temporary. But beliefs of that kind today are less firmly held, and the uncertainties are greater, than they were in the past. Stabilizing speculation therefore may not operate as effectively as it once did. This increases the importance of official reserves. But it does not give us guidance as to how far these reserves should be used to even out exchange rate fluctuations expected to by cyclical in nature. The problem of the dollar today, I believe, is mainly of this cyclical character.

The Position of the Dollar

To date, the dollar continues to be the principal reserve and intervention currency. It is bought, sold, and held by foreign central banks in accordance with their own exchange rate objectives. For the United States, this produces a situation not altogether different from that which existed before floating began. Other countries largely determine the exchange rate of the dollar, to the extent that this rate is influenced by intervention.

One of the U.S. objectives of international monetary reform has been to achieve a greater degree of influence over its exchange rate. Intervention in a floating system is one way of exerting such influence. The worldwide use of the dollar for intervention by other monetary authorities to influence the value of their currencies, however, tends to outweigh by far the effect of intervention specifically aimed at influencing the value of the dollar.

Intervention, moreover, today may take on new forms. Governments, or political subdivisions, or other official entities may borrow in the Eurodollar market with the ultimate objective of influencing the exchange rates. It is not necessary that the funds so raised go to the central bank. If the borrowing agency sells them directly in the market, the effect tends to be the same as that of a sale by the central bank. Thus, official borrowing becomes one of the major aspects of foreign exchange policy. Viewed as mediumterm or long-term capital imports, these borrowings become part of over-all balance-of-payments receipts and so offset current account deficits. Their principal purpose today is to finance oil imports. But at the same time, these operations clearly represent a component of foreign exchange and intervention policy and as such have become an important new feature of the international monetary system.

The objective of such dollar intervention by third countries need not be to influence the rate between the dollar and the currency in question. It may be designed primarily to influence the rate between that currency and third currencies, for instance those of the Snake or of other European Community currencies. The effect, however, of putting dollars into the market -- or removing them -- is to change the rate of the dollar with respect to all currencies. The supply of dollar assets in the world is increased, if dollars are sold, and reduced, when dollars are bought. This has the usual consequences that follows from any shift in the balance of supply and demand.

The volume of assets in the financial markets of the world is very large, and thus one would suppose that the use of dollars for intervention would not change the worldwide balance of supply and demand of dollars very much. That is indeed true, as indicated by the relatively moderate fluctuations of the dollar in terms of its trade-weighted effective rate against the currencies of the major industrial countries.

In 1974, the dollar's effective exchange rate -- as measured by a weighted average of the price of the dollar in terms of ten major foreign currencies -- ranged from a high in January of an 11.5 per cent depreciation relative to May 1970 exchange rates to a low in May of an 18.3 per cent depreciation, a variation of about 8 per cent in the dollar's effective exchange rate in terms of this particular weighted average measure. Thus far in 1975, the dollar's effective exchange rate has declined by about 3-1/2 per cent. But changes in the dollar's value vis-a-vis certain major European currencies have been much greater in recent periods. In 1974 the Swiss franc's high against the dollar was about 29 per cent above its low and the highest dollar price of the German mark that year was nearly 15 per cent above the lowest. So far this year the Swiss franc and the German mark have appreciated against the dollar by about 5 per cent and 4 per cent respectively.

The appearance of fluctuations much wider than those of the effective rate, or those of the dollar in terms of the SDR, is magnified by the fact that one of the principal exchange markets for dollar intervention is the market for DMarks. It is further intensified by the manner in which exchange rates appear in public discussion and especially in the press. Perhaps it is natural that every country should take what may be called a Ptolemaic view of its currency in relations to the rest. The home currency is viewed as fixed, other currencies, including the dollar, are regarded as going up and down. Hence the familiar headline to the effect that "the dollar today fell -- or rose -- by "X" per cent." A Copernican view of exchange markets would suggest that the home currency would be regarded as moving up and down, not so much against the dollar, but against the totality of other currencies, i.e., in terms of its effective rate, or against the SDR. The Copernican view, however, appears mainly in the American press when exchange market reports are filed by correspondents abroad leading to headlines such as "dollar plunges -- or recovers -- in Zurich."

But while the customary form of registering exchange rate movements in the market intensifies the appearance of fluctuations, it is nevertheless true that the fluctuations of the dollar constitute a serious problem. It is not possible, as some academic proponents of floating rates urge, to ignore the movement of the rate, and the United States government has never done this. In present conditions, the need for a more deliberate policy on the part of the United States with respect to the dollar becomes more evident. Such a policy should, of course, be directed toward equilibrium and not toward futile attempts to fight fundamental trends. It should be a cooperative policy. At a time particularly when large-scale use of the dollar for intervention may distort the dollar rate in a manner nobody desires, such a policy should contribute to the achievement of better equilibrium for all countries.

Policies for the Dollar

Such a policy must begin with fundamentals. The United States is now engaged in a simultaneous effort to overcome a recession which began last year and to end an inflation that had its origin a decade ago. The world cannot easily be prosperous unless the United States recovers its prosperity. Confidence and stability cannot easily return to world exchange markets so long as the outlook for the United States is viewed with uncertainty. But neither will these markets return to solidly based exchange rates unless inflation is defeated. The United States has made a great effort to overcome its inflation, involving major sacrifices in output and employment. The United States believes these sacrifices will be recouped through higher levels of economic activity and growth in an inflation-free economy. At the present time, the principal effort to overcome recession is being made on the fiscal front, where it is least likely to generate adverse pressure on the balance of payments.

The severity of the recession has turned the American balance of payments in a negative direction, as has happened in most other recessions. Historically, while the current account has improved in recession, capital outflows encouraged by low interest rates often have outweighed that effect and have pushed the over-all balance of payments toward deficit. In the present recession, the mounting cost of oil imports and the sharply declining foreign profits of oil companies have produced a rising current account deficit despite the restraining effect on imports exerted by the recession. Federal Reserve policy directed toward moderate growth of the monetary aggregates meanwhile has pushed down interest rates because the money supply has stagnated as the economy reduced its demand for transactions balances. These essentially cyclical developments have contributed to the weakness of the dollar.

In the last few months, inflation has slowed markedly. The consumer price index, in recent months, has been moving at a diminishing annual rate reaching 8 per cent in January. The wholesale price index has been virtually stable for two months. These are important milestones on the road to better price performance.

Concerns have been voiced, in the United States and abroad, that fiscal expansion will become excessive, and that this will lead to the renewed inflation and weakening of the dollar. For those who stress this pessimistic scenario it would be worth noting that the immediate effect of excessive government deficits would be to drive up interest rates which in turn would threaten to choke off recovery. While renewed inflation would tend to depress the dollar, higher interest rates and a damped recovery would not. I regard as more probable, however, a course of events that brings the United States back to prosperity with a steadily diminishing rate of inflation. In that situation, the dollar would be in a position to demonstrate its fundamental strength.

Meanwhile the evolution of the international monetary system toward new structures and institutions is progressing. A financial support fund is being created to meet the urgent needs of countries that have no access to credit or would confront unacceptable terms. Agreement has been reached to enlarge the size of the International Monetary Fund. Some progress has been made towards a better definition of obligations of countries whose currencies are floating and their rights to choose such a regime, which the United States regards as essential, subject to the IMF's guidelines for floating, in view of the worldwide use of the dollar over which it can exert no control. A better understanding of the means to reduce the role of gold, as agreed by the Committee of Twenty, is underway. Taking all in all, I believe that this adds up to a progress report.

#