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Statement by

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and the

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I am pleased to appear before these Committees to discuss the five questions posed by Chairman Rees' letter of June 26. In order to be as responsive as possible to the Committees' needs, I have organized my remarks today into five sections to correspond with the concerns raised by your Chairman.

Evaluation of experience with flexible exchange rates

After floating first became general in March 1973, early evaluations of floating exchange rates were marked by considerable relief and satisfaction that international trade continued to expand and that exchange markets functioned well. Both the business community and governments seemed to adapt quickly to the new system. Governments did not then, and on the whole have not since, resorted to administrative controls or competitive depreciation to improve their current account positions at the expense of others. The absence of controls together with increasing familiarity with techniques available for minimizing risks associated with exchange rate changes have considerably reduced initial skepticism towards floating rates expressed by some members of the business community.

Recently, however, increasing criticism of floating rates has been heard. The most prevalent criticism is that exchange rate fluctuations have been excessively wide. The fact that many effective exchange rates (a term I will examine more closely in a moment) have returned to about the levels at which they stood in March 1973, or shortly thereafter, seems to suggest that the interim fluctuations were unnecessary.

Some observers go further and argue that temporary declines in exchange rates which have occurred have been inflationary in many countries through a ratchet effect on cost-price structures.

Moreover, monetary policies of non-reserve-currency countries have not been as independent under floating rates as some had expected. Monetary policies that generated and were constrained by unwanted flows of financial capital among countries under fixed exchange rates seem to have generated and to have been constrained by unwanted changes in exchange rates under a regime of greater flexibility in exchange rates.

Another aspect of the world monetary system that has attracted attention of late is the fact that it is not a system of freely floating exchange rates. It is a mixed system: some countries peg their currencies to the currency of a major trading partner; some blocs, or groups, of countries maintain stable rates among themselves while floating more freely with respect to the rest of the world; some countries actively manage their float to a greater or lesser extent by intervention in their exchange markets; and a very few countries, among them the United States, float -- to the extent that the interventions of others will allow them -- with a relatively small amount of intervention.

Recent criticisms of floating exchange rates contribute to our understanding of the current world monetary system and deserve to be weighed carefully. On the other hand, it would be a mistake to allow these criticisms to overshadow the benefits that greater exchange rate flexibility has yielded. Exchange rate fluctuations have been large, to be sure, but in good part these fluctuations

have reflected the disturbed nature of our times. Since March 1973 we have experienced high and unpredictable rates of inflation, a worldwide recession, and the end of the boom in commodity prices. Massive increases in oil prices have produced large shifts in trade flows, and the problems connected with the recycling of OPEC investments to countries in need of financing have created further uncertainties. Finally, considerable uncertainty has prevailed concerning the preferences of OPEC members for various financial assets. Assessments that could be made by market participants of the probable impacts of these factors on individual countries have changed rapidly. These changing assessments have in turn generated large changes in exchange rates. But such shocks to the world economy would have required unusually large and frequent exchange rate changes under any monetary system and would probably have resulted in some exchange market crises under a regime of fixed exchange rates. As a practical matter, there has been no alternative to greater flexibility in exchange rates, and for some countries there may be none for the foreseeable future.

The problems of the present system have been exaggerated by a tendency of public attention to concentrate on those foreign currencies showing the widest fluctuations vis-a-vis the U.S. dollar. This in part reflects the fact that in some cases an upward trend in a currency has tended to attract increasing activity into the market for that currency as speculative interest in it has mounted. In particular, wide swings in the DMark and in the Swiss franc against the dollar have dominated the news from the exchange markets. But all foreign currencies

do not move up and down against the dollar at the same time or at the same rate. And it is misleading to describe the movement in the dollar by concentrating on a particular foreign currency that is currently the center of market attention. The dollar has risen since March 1973 with respect to several major foreign currencies including sterling, the Canadian dollar, lira, and the Japanese yen.

With this in mind, analysts have constructed weighted averages of countries' exchange rates; these calculations are sometimes labelled the "effective exchange rate" of a particular currency. I have provided a brief description of alternative methods of calculating effective exchange rates in the appendix to this testimony. For the U.S. dollar, in contrast to some other currencies, alternative measures of an effective rate yield rather similar results.

To what extent should central banks intervene in exchange markets?

Floating has been tempered by official intervention in exchange markets. The old system of fixed rates required intervention to be carried to the point of nearly complete stability. Under floating, intervention has usually been carried less far. But some countries, including Germany, Switzerland, France, Italy, Japan, and the United Kingdom, have intervened on a substantial scale in attempts to modify the exchange value of their currencies. The first two countries have intervened predominantly to moderate the appreciation of their currencies, while intervention by the others has been directed predominantly, but not exclusively, toward supporting their currencies.

Intervention initiated by foreign governments to support their currencies has been financed, as in the past, partly by the accumulation or reduction of reserves. But in some cases recent intervention has been financed by official borrowing of dollars on private credit markets, particularly the Eurodollar market. In addition, some "intervention" has not directly involved governments at all but has taken the form of officially directed borrowing of foreign currencies by state-controlled firms. These officially directed transactions have the same impact on exchange rates as more traditional forms of exchange market intervention. To give just one indication of magnitudes, in the first half of 1974 alone exchange-market intervention of all these types together amounted to nearly \$20 billion.

The great bulk of intervention by foreign countries occurs in dollars. While the intent and principal effect has been with respect to the currency of the intervening country, a significant effect has been exerted thereby upon the dollar. Sales of dollars in support of sterling, the French franc, and the lira tend to raise these currencies relative to the dollar. At the same time, the action tends to depress the dollar with respect to other currencies. Hence, while some dollar intervention has been supportive of the dollar, on balance intervention by central banks financed with reserves or with borrowed dollars has in some degree depressed the dollar.

In contrast to dollar intervention initiated by foreign governments, intervention initiated by the United States since March 1973 has been quite modest and limited in its purpose to maintaining orderly market conditions by smoothing temporary and disruptive fluctuations in exchange markets.

Disorder in exchange markets may take several forms. One such form is a widening spread between bid and offer rates. In times of extreme disturbance, bids and offers may disappear altogether. Rate movements that are relatively discontinuous represent another form of disorder. Some participants in exchange markets engage in frequent in-and-out trading based on very short-term objectives; fluctuations generated by such trading may temporarily swamp more fundamental factors. Various other circumstances may temporarily block a response to fundamentals.

When appraising exchange-market intervention by the United States, it is important to remember the difficulties and constraints that necessarily circumscribe these operations. The total volume of financial assets denominated in U.S. dollars may be on the order of \$5 trillion, including substantial amounts held by foreigners in the United States and in the Eurodollar market, and a relatively large proportion of these dollar assets is internationally mobile. Hence potential shifts between the dollar and foreign currencies are very large. The potential scale of U.S. intervention, moreover, would be bound to remain modest, given the small size of U.S. reserve assets, the gross amount of which currently stands at about \$16 billion. The swap facilities utilized by the Federal Reserve to finance exchange-market intervention are designed to be short-term credits and not substitutes for reserve assets. Finally, the United States at times faces a significant technical difficulty because, in order to intervene on any but a modest scale, it would have to intervene in many foreign currencies.

Since we are larger than other countries, United States intervention in just one foreign currency could substantially distort the exchange rates between that one currency and all other foreign currencies.

Because of the important role that foreign official intervention plays in current exchange-rate arrangements, guidelines for intervention within the existing mixed system of exchange rate arrangements have been developed by the Committee of Twenty. As adopted in June 1974 by Executive Directors of the IMF, they are the first step in outlining the rights and responsibilities of countries within the evolving system. The guidelines encourage intervention designed to maintain orderly market conditions by mitigating day-to-day and week-to-week exchange rate changes. A member may also intervene to moderate movements in exchange rates over longer time periods (month-to-month or quarter-to-quarter) where factors recognized to be temporary are at work. The guidelines also allow countries to establish target zones for exchange rates or for the development of their reserves in consultation with the Fund -- although, to date, no country has attempted to specify zones for exchange rates or for changes in their reserve positions. These guidelines allow greater scope for intervention than we are willing to utilize.

The guidelines also recognize that members who engage in exchange-market intervention should bear in mind the interests of the issuing countries in whose currencies they intervene. Since most intervention involves dollars, the U.S. has a legitimate concern in this regard.

Before leaving the subject of intervention in exchange markets, I would like to point out that monetary policies, and in particular central bank operations in domestic financial markets, have important implications for exchange rates. This is especially true for a currency such as the dollar since U.S. money markets are free of direct controls and since the dollar is widely held by individuals and firms that are sensitive to interest rates on alternative foreign currency assets. However, most countries -- and, again, particularly the United States -- find it in their interest to give priority to domestic objectives in determining their monetary policies. Hence monetary policies may have unwanted repercussions in exchange markets -- an easing of monetary policy, for instance, producing a weakening in the exchange rate, possibly with inflationary consequences. Within limits, exchange market intervention may be able to cushion such effects.

Should authorization by the IMF be required for a country to float?

The constraints which circumscribe intervention operations described in the foregoing discussion apply a fortiori to the extreme case of intervention -- that is, attempted maintenance of a fixed rate. Such a fixed rate would be implied if the IMF had the power to deny to a member the right to float its currency, since the alternative to floating is a fixed rate maintained by intervention, or controls, or tight policy coordination, or some combination of these. The right of a country to float without prior authorization by the IMF was one of the principal matters in dispute at the recent meeting of the IMF Interim Committee in Paris.

Exchange rate stability is preferable to instability. But for reasons already given, it would be difficult for the United States to maintain exchange rates within narrow margins by intervention alone, and undesirable to attempt to do so.

Nor does close policy coordination offer a viable alternative as a means of maintaining exchange rates within narrow margins, at least for a large country like the United States. Smaller countries may find it preferable to limit their freedom of domestic policy in order to obtain the benefits of more stable international economic relations. For a large country with a foreign trade sector that is small relative to its domestic economy, a proper ordering of priorities points in the opposite direction.

Even a commitment to maintenance of exchange rates within narrow margins for a temporary period would have to be carefully safeguarded by an agreed adjustment

mechanism. In such a mechanism, surplus and deficit countries would have to share the burden of adjustment, and it would also have to allow for changes in rates, perhaps along the lines of the outline of reform negotiated by the Committee of Twenty of the IMF.

These problems associated with a system of convertible currencies based on fixed rates make clear that an option to float must be available as part of the Fund's exchange rate regime. A system under which a country could be denied the right to float, or where some time limit for returning to fixed parities was specified, or where floating countries could be penalized in some form, would not meet the foreseeable needs of the United States.

A floating rate regime, of course, is not a license for uncooperative foreign exchange practices. A country with a floating currency can be a good international citizen and has an obligation to act responsibly and fulfill its international commitments. A commitment to cooperative behavior, rather than to a particular form of exchange rate regime, should be at the core of a country's obligations to the IMF.

The role of gold as a reserve asset and sales of gold by the IMF

As I have indicated, the appropriateness of particular exchange-rate arrangements will depend in theory and in practice on the nature of other aspects of the international monetary system, such as the place of reserve assets in that system. Similarly, the issue of the possible use of the gold now held by the International Monetary Fund must be examined in the context of the broader issue of the relationship between gold and other reserve assets in the international monetary system.

As you know, the United States wants to ensure that the role of gold in the international monetary system is gradually reduced. International rules of behavior should be structured to help achieve this objective. These might include: (1) A prohibition on any arrangements that would have the effect of fixing a price, or a price range, for gold. (2) A global limitation on the holdings of gold by governments and the International Monetary Fund taken together; no government would be allowed to purchase gold from the private market if such a purchase would push total holdings above the global limit. (3) Prohibition of gold transactions among monetary authorities, except in special circumstances, such as an emergency need for a country to mobilize its gold holdings; gold would not be used, directly or indirectly, as a means of settling payments imbalances except in such special circumstances. (4) Continuation of the right of individual countries to sell gold to the private market.

Rules governing the use of gold in transactions with and directly by the International Monetary Fund are also needed, such as that gold should no longer be accepted by the Fund either for quota payments or for any other purpose, and that the Fund should be granted the same authority that each member government now has to sell gold from its present stock in the private market. The proceeds from such gold sales by the IMF should be used for internationally agreed upon purposes. Mobilization of a portion of the IMF's gold through sales in the private market could add to the resources available to assist those countries most seriously affected by the rise in oil prices; such sales would also help to ensure that the stock of monetary gold is gradually reduced.

Sales of the IMF's gold on the private market should not be designed to fix the market price of gold. Such sales, together with an effective global limit on the stock of officially held gold, would make it more difficult for individual governments, if they were so inclined, to fix the market price of gold. The announcement of a program of sales of IMF gold on the private market could depress the price of gold if the announcement took the public by surprise. But once the market adjusted to the prospect of

increased supplies from this source, the actual sales should not have a particularly pronounced effect on the market price. Moreover, such sales by the IMF are likely to be small and gradual.

The danger of manipulation of the gold price as a consequence of Fund sales of gold is further reduced by more general considerations. An attempt by any country or group of countries to fix an official price of gold would encounter severe difficulties owing to the existence of a free market for gold. An official price could not long deviate from the free price since monetary authorities would not wish to sell at prices below the free price and would not wish to buy above it. Maintaining equality between a fixed official price and the free price would require at least one monetary authority to stand ready to buy or to sell unlimited quantities of gold. Such an arrangement was attempted under the so-called Gold Pool arrangements in the 1960's and proved unworkable.

The establishment of rules of conduct for individual governments and for the IMF along the lines I have indicated is consistent with the objective of gradually reducing the role of gold in the international monetary system. Yet a gradual approach to this problem is clearly essential since gold is an important asset in the international reserves of a few countries. It is unrealistic to think that this asset can be eliminated from the international monetary system overnight. Instead, its role in the international monetary system should be gradually, effectively, and equitably reduced.

The role of the dollar as a reserve currency and the "dollar overhang"

I turn now to the question of the role of reserve currencies, and particularly the role of the U.S. dollar, in the international monetary system. In analyzing this subject, and particularly in considering the so-called dollar overhang, it is necessary to keep in mind the multiple roles of the dollar in the international monetary system: the dollar is both the world's most widely used intervention currency and its principal reserve currency; the dollar is used by firms and individuals in many countries both to denominate and to execute their transactions; and, finally, dollar-denominated assets and liabilities are both widely held and issued by firms and individuals around the world.

Traditionally, the term dollar overhang has been applied to the holdings of dollars by foreign monetary authorities that are thought to be in excess of their desired holdings. Leaving aside the accumulations of dollar-denominated assets by the oil-exporting countries, which are more properly viewed as investments and not as reserves, the bulk of the dollar balances now held by foreign monetary authorities was accumulated before the widespread adoption of floating exchange rates in March 1973. In defense of their exchange parities, several countries accumulated massive amounts of dollar reserves in 1970-71 and in early 1973. There is no way of knowing whether or not all of these balances are now "willingly" held, but on the basis of the following factors there is reason to believe that for the most part they are.

First, since March 1973, under a regime of floating exchange rates, the accumulation of dollars by foreign authorities is no longer an obligation but rather an option. Some countries may on occasion intervene to hold down their exchange rate and so accumulate dollars and expand their money supply rather than see their currencies appreciate. Even if one were to regard these dollars as "unwanted" even though they were acquired by choice, the inflows may be quite unrelated to the U.S. balance of payments. Intervention may be engaged in by EEC members, for example, for the purposes of keeping snake currencies within their agreed upon margins. Alternatively, a country may be faced with the choice of intervening in dollars or letting its exchange rate appreciate or depreciate as a result of attempted movement of OPEC funds.

Second, the recent uncertainties and balance of payments difficulties associated with the rise in petroleum prices has put a premium on the holding of reserves. This development strengthens the presumption that current official holdings of dollars are willingly held.

Third, as indicated earlier, countries have frequently borrowed dollars on the international capital markets and have used these dollars in order to intervene in the exchange markets instead of reducing their actual holdings of dollars. This is indicative of a desire to preserve existing levels of reserves.

Fourth, some countries that have very large dollar accumulations received these in part through an inflow of liquid capital. These funds could depart some day and therefore may make desirable the maintenance of somewhat larger reserves.

It tends to be misleading, therefore, in the present environment to view official dollar holdings as an "overhang." The possibility exists, of course, that countries now holding dollars willingly may change their mind. In any event, even to the extent that observers do speak of an "overhang," the United States cannot necessarily be held responsible for it.

The concept of the so-called dollar overhang has sometimes been extended to include private holdings of dollar-denominated assets, particularly those taking the form of Euro-currency claims. In my view, such an extension of the concept of the dollar overhang lacks economic meaning. At any moment in time these private claims are willingly held. For the most part, they represent the liquid assets of enterprises and investors that are required for the normal conduct of their operations.

It is true, of course, that the private demand for dollar-denominated assets, as against assets in other currencies, is subject to change. If countries desired to offset the pressures on exchange rates that result from such shifts in asset demands, they would have to buy or sell dollars in the exchange markets. Official purchases of dollars under such circumstances could conceivably be interpreted as additions to the potential dollar overhang in the more traditional sense of the term. In the present environment, however, situations in

which market pressures lead countries to sell dollars are as likely to occur as situations in which countries are led to purchase dollars. Countries are not obliged to do either.

The use of the dollar as a reserve currency, which is the corollary of the concern about an "overhang," has associated costs and benefits from the U.S. perspective. The main advantage for the United States has been the greater flexibility of balance-of-payments financing that this country has experienced because it could issue liabilities in settlement of a deficit. This presumed advantage, of course, is greatly reduced under a regime of floating exchange rates. On the other hand, the use of the dollar as a reserve currency has diminished our freedom to pursue an active exchange rate policy. As I have noted above, foreign intervention decisions have a strong influence on the exchange value of the dollar, sometimes in ways detrimental to U.S. objectives.

I believe that on balance the use of the dollar as a reserve currency has made an important contribution to the smooth functioning of the world economy during its recent, severe difficulties. For the longer term, however, the role to be played by the dollar and other reserve currencies in the international monetary system is an important, open question. A consolidation of dollar reserves into SDRs has been suggested. A consolidation of dollar

reserves may well be involved in the eventual establishment of the SDR at the center of the international monetary system. But such proposals raise questions regarding terms -- interest rates, exchange guarantees, amortization provisions -- that were discussed during the Committee of Twenty negotiations. The answers to these questions are, of course, crucial to the interests of the United States.

I would not want to prejudge the issue of consolidation. It may well be that as the international monetary system evolves, the case may gain in persuasiveness. We are fortunate to have been able to observe the operation of the international monetary system in the past two years without being forced by events into hasty arrangements that might not have stood the test of time. The task for the future is thoroughly to analyze and build on the experience we have accumulated.

APPENDIX

ALTERNATIVE MEASURES OF EFFECTIVE EXCHANGE RATES

The weights assigned to market exchange rates in the calculation of an effective exchange rate reflect alternative measures of the relative importance of the different countries whose currencies are taken into account in the calculation.

One method of calculation is based on so-called "bilateral trade shares." For example, in calculating the effective rate for Germany, the dollar-Dmark exchange rate would be weighted by the share of German-U.S. bilateral trade in total German trade; the yen-DMark exchange rate would be weighted by the share of Japanese-German bilateral trade in total German trade; and so on for the other exchange rates taken into account in the calculation. Effective exchange rates calculated in this manner tend to emphasize the close relationships of a country's currency with respect to the currencies of its major trading partners. Some foreign currencies that have had wide variations in exchange rates vis-a-vis the dollar have been far more stable with respect to the currencies of their bilateral trading partners. For example, the Belgian franc's effective rate using bilateral trade weights has fluctuated in a range of only 6-1/2 per cent since March 1973, while the market exchange rate of the Belgian franc against the dollar has varied in a range of roughly 25 per cent over the same time period. The effective

rate of the U.S. dollar meanwhile, calculated in an analogous fashion, has varied over a range of 8 per cent.

The bilateral trade weights employed in the calculations I have just described take into account direct trade relationships among countries, but they do not take into account important effects on export competitiveness in third countries. For example, Germany and Japan do not have a large bilateral trade relationship with each other, but German automobiles and Japanese automobiles clearly compete in the U.S. automobile market. In evaluating Germany's overall competitive position in world markets, it may be more reasonable to assign a weight to the Japanese yen which reflects Japan's share of world trade rather than its share of trade with Germany alone (and similarly for other currencies). An alternative method for calculating effective exchange rates thus employs such "multilateral trade weights."

The weights used by the IMF to calculate the value of the SDR in terms of individual currencies were selected to reflect the overall economic importance of various countries, and are similar to multilateral trade weights. The SDR value of a country's currency is therefore very similar to an effective exchange rate for that currency.

Still another alternative calculation of a weighted average exchange rate may be obtained from a world trade model such as that constructed by the Research Department of the IMF. An effective exchange rate computed on this basis attempts to

weight currencies according to their estimated impact on the trade balance of the country whose effective rate is being calculated.

For some countries, these alternative measures of a weighted average exchange rate give substantially different measures of exchange-rate variability. For example, effective exchange rates for Canada or some European countries calculated with bilateral trade weights exhibit greater stability than effective rates based on multilateral trade weights. For the United States, this is less true; all the alternative measures yield broadly similar results for the entire period of floating. For the first half of 1975 in particular, the alternative measures of a dollar effective rate move together within a narrow range.