

FOR RELEASE ON DELIVERY
Monday JUNE 18, 1979
5:00 P.M. LOCAL TIME (12 NOON EDT)

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Remarks by

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

at a meeting sponsored by the

Landeszentralbank in Berlin

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It is a pleasure to address this distinguished audience in my former hometown, and to review with you the international monetary and economic situation. When I last lived in Berlin, international finance was very much in the foreground of discussion, because there had been a big banking crisis and exchange controls had been introduced. From that early experience, a deep impression has remained -- and I am sure I am speaking for everybody who lived through the crisis of 1931 -- of the enormous problems created by that kind of system, and of the great importance of avoiding a relapse. This makes a review of the international financial system particularly appropriate in this place and time.

Experience with Floating Rates

The floating exchange rate system has helped us to overcome a period of great difficulties characterized by the oil crisis, a world recession, and high rates of inflation. But there seems to be a widespread sense of uneasiness about the working of this system and where it may take us. There also seems to be a broad-based belief that the

exchange rate fluctuations that have occurred within the floating system have been excessive and that we should act to reduce them. Evidence of these beliefs is the creation of the European Monetary System and the policies initiated in the United States on November 1 of last year.

I would like to examine the sources of this dissatisfaction with the floating rate system. It is easy enough to point to its defects. But these defects must be evaluated relative to some feasible alternative. There is no doubt that if we could have fixed rates while continuing to enjoy free movement of goods and of capital as we do, that would be preferable. But that is not the option. Worldwide fixed rates could be achieved today, if at all, only by a system of tight trade and exchange controls. That is not an acceptable alternative. We must ask ourselves, therefore, what we do not like about the floating system and how its defects could be remedied.

It is fair to say that the floating system, when it was imposed on the world by force majeure, was oversold and overadvertised. It was thought that the system would allow each country to pursue the domestic policies of its choice, unimpeded by balance-of-payments constraints. It was also thought that the system would insulate national economies against international disturbances. We have seen that this did not happen. While individual country experience naturally differs, countries generally found their domestic policy choices constrained, because efforts, for instance, to stimulate the domestic economy quickly led to depreciating exchange rates and consequent domestic inflation. Efforts to curb inflation created the risk of making a currency too attractive, leading to excessive exchange rate appreciation or the need for exchange market intervention that threatened to undermine price stability by excessive increases in the money supply.

The promise of speedy adjustment of payments imbalances through exchange rate movements has remained unfulfilled, perhaps because the very ease with which exchange rates could move has diminished political pressure to adopt appropriate fiscal and monetary policies.

The ups and downs of exchange rates have tended to accelerate world inflation because prices rose rapidly where currencies declined but remained sticky where currencies appreciated.

Vicious circles seem to have developed in which exchange rate depreciation feeds inflation and accelerating inflation, in turn, feeds back upon the exchange rate. Countries with appreciating currencies have found themselves caught up in virtuous circles, with cheaper imports reducing inflation and reduced inflation further strengthening the currency. These vicious and virtuous circles have threatened to polarize the world into countries with strong and weak currencies which has come uncomfortably close to splitting the world into strong and weak countries.

It is not surprising, therefore, that the evolution of the world's monetary system has brought us to a phase in which exchange market considerations have become a major priority. Both in Europe and in the United States, this new orientation has led to new forms or at least a new scale of exchange market intervention. It is important to be clear, however, what exchange market intervention can accomplish and what it cannot. Exchange-market intervention can deal with movements which are overly rapid and clearly excessive, of the sort that plainly seem to have occurred. We have lost the earlier faith, if ever we had it, that the market would at all times set exchange rates at the right level. Intervention that counteracts market disorder and helps fundamental factors to

assert their influence over exchange rates is promising. Not only does it hold out hope of minimizing the cost of excessive fluctuations, it can also contribute to greater stability of prices, trade, and economic activity generally and thus, again, to greater exchange rate stability. A pre-condition of such intervention is recognition when exchange-rate movements require correction. Nobody can say with any assurance what is the "right" exchange rate. But it should not be impossible to recognize market disorder which is producing rates that are clearly wrong.

Intervention in exchange markets will not succeed if it runs counter to fundamental economic developments. That has been proved abundantly by the failure, in 1977 and the first part of 1978, of the efforts of central banks to stem the decline of the dollar. It was only after U.S. policies, in combination with the decline in the dollar, had succeeded in putting the U.S. payments deficit on a clearly declining trend that intervention became promising and was indeed successful. In combination with a high level of interest rates and much improved budgetary picture, intervention was successful in correcting some of the excesses that had occurred in the exchange market.

Lasting stability of exchange rates can come only from stability and international compatibility of the fundamentals -- prices, growth, interest rates, and payments balances. National policies, particularly with respect to inflation -- and I regret that I must say this particularly of the United States -- have left much to be desired. The growing dissatisfaction with instability of exchange rates provides a further impetus to improve performance in these areas. In other words, if the world wants

more stable exchange rates, it must accept a stronger balance-of-payments discipline. Efforts to combat inflation will gain strength from the perceived desirability of reducing exchange rate fluctuations.

Inflation and exchange rates are related, of course, also in an inverse sense. Not only is exchange rate stability dependent on control of inflation; the reduction of inflation, in turn, can be aided by an upward movement of the exchange rate. This had become very apparent in the countries that have had rising exchange rates. The contrary -- a falling currency causing additional inflation -- has been observable in the United States. Exchange rate policy thus becomes an instrument in the effort to overcome inflation. It should be clear, however, that it is a very limited instrument. Any effort to push exchange rates to unrealistic levels is condemned to failure in the light of the predictable reaction of the markets. Furthermore, such action on the part of any one country could only be at the expense of all the rest. A stronger exchange rate for one country means a weaker rate for others. Less inflation for the first country, therefore, means more inflation for the rest. Only the correction of any prevailing undervaluation of an exchange rate is an appropriate instrument of anti-inflation policy.

Furthermore, while each country should seek to achieve an exchange rate that permits appropriate balance in its external accounts, with appropriate allowance for capital movements, it is clear that this should not be done by seeking to coordinate rates of inflation at some common denominator. The world has learned -- some countries, indeed, had no need to learn -- that inflation is an evil. A prosperous and socially just economic system is not possible without honest money. The objective

everywhere must be, therefore, not to coordinate rates of inflation, but to reduce them. The proper function of exchange rates in this process is to move so as to maintain payments equilibrium. When all major countries will have achieved reasonable price stability, should that day ever come, the need for exchange rate movements will have been minimized.

Reserve Currencies

A more active intervention policy, relative to market conditions, requires consideration of the currency or currencies in which intervention is to be conducted and reserves are to be held. In the past, the dollar was the world's principal, and for most countries sole, reserve and intervention currency. The United States, meanwhile, relied principally on swap arrangements with foreign central banks to obtain the means of intervention. In execution of the policies initiated on November 1, the United States has become a country holding foreign currency reserves of some magnitude, through actions such as borrowings by the Treasury in D-marks and Swiss francs, sales of SDRs, and drawings on the International Monetary Fund. As a result, the United States now holds reserves in D-marks, Swiss francs, and Japanese yen. This allows somewhat greater freedom of action than sole reliance on swap facilities.

Numerous other countries meanwhile have also added D-marks, Swiss francs, yen, and other currencies to their reserves. This is a change from past practice, when the dollar was regarded as the obvious intervention medium because of its wide international usability, the ease with which investments of reserves balances could be made and liquidated in the U.S. money market, and the economies in transactions costs that resulted from these circumstances. Recently,

some holders of international balances have taken a portfolio approach to the investment of their reserves, seeking to reduce risk and stabilize return by diversification. These activities probably have contributed in some degree to exchange market instability, although they have not as of now, impeded the recovery of the dollar from the low levels of October 1978.

In this way, the D-mark, the Swiss franc, and the yen have moved further along the road to being reserve currencies while only sterling has dropped out. The world as a whole has moved a step further along the road to a multi-reserve currency system. The brief experience of the United States in holding foreign currencies for intervention has revealed some relatively minor technical problems that nevertheless deserve to be examined among the pros and cons of a multi-reserve-currency system. Investments in the currencies acquired cannot be made with the same ease with which investments can be made in dollar assets. This is partly the result of controls on capital inflows of some of the incipient reserve-currency countries. More broadly, however, it reflects the relative narrowness of their financial markets and the fact that large-scale operations in these currencies, both for investment and for intervention, have consequences for the monetary, foreign exchange, and capital market policies of these countries. Countries holding dollars as reserves have rarely found it necessary to engage in negotiation or even consultation with the United States when they needed to invest or mobilize funds or intervene in exchange markets to buy or sell dollars. The natural breadth of U.S. financial markets has been assisted in achieving this result by special investment facilities offered by the U.S. Treasury through non-marketable issues of U.S. Government obligations. This has resulted in a very

flexible use of the U.S. dollar by foreign monetary authorities. Given the different structure of the financial markets of the incipient reserve currency countries, the question arises whether it is possible or advisable for them to offer the same kind of facilities.

The German and Swiss authorities have made it clear that they do not welcome the advancement of their currencies to reserve currency status. The Japanese authorities appear to be taking a neutral attitude, neither favoring nor inhibiting the development of the yen as a reserve currency. The German and Swiss authorities seem to be concerned about both the exchange rate and the financial market implications of large international flows in their currencies. Past experience indicates that these movements can indeed cause serious disturbances for monetary and foreign exchange rate policies.

From an American point of view, I believe, these concerns are entirely understandable. They throw a new light upon the often-made claim that the United States has taken unfair advantage of the dollar's role as a reserve currency. It is true that at times the United States has received easy financing of its international deficit thanks to that role of the dollar. On the other hand, that role has often been a severe burden. It has caused exchange rate movements that were unrelated to the U.S. balance of payments. It has at times constrained the ability of the dollar to reflect fundamentals of the exchange market, by forcing the United States into the familiar role of the "n-th currency," i.e., that of a country that must be passive with respect to its exchange rate because that rate is determined by the exchange market intervention decisions or policies of the "n - 1" other countries. The reserve role of the dollar



has not interfered with U.S. monetary management, perhaps not so much because of the sheer size of the U.S. short-term financial market as owing to the presence in that market of nonbank investors, including business firms and individuals, which allows the Federal Reserve to control more effectively bank reserves and money supply. This facility is largely lacking in the incipient reserve currency countries.

But perhaps the principal burden of being a reserve currency country comes from the softening of balance-of-payments discipline that such a country experiences. It may be helpful from time to time not to have to take unpalatable fiscal or monetary policy measures to restore balance-of-payments equilibrium. But that is a benefit often dearly bought at the price of trouble later. The countries that today are candidates for reserve currency status do not need and would not benefit from the balance-of-payments support that this role can bring. Neither did the United States in the days after World War II when the dollar became the world's reserve currency. It seems to be the nature of the process by which the market elevates particular currencies to reserve currency status that the market first singles out currencies precisely because they are strong, and that performance of the reserve role subsequently weakens discipline and weakens the currencies. Being placed in the passive role of an "n-th currency" whose exchange rate is determined by the exchange rate decisions of the "n - 1" contributes to this weakening. Weakening of discipline and the passive role of an "n-th currency" have been the experience, in my view, of, first Britain, and then, the United States. It is difficult not to have sympathy for the reluctance of some countries to take the risk of moving along that road.

From the point of view of the world economy, a multi-currency reserve system has still another risk. This is the risk that, during the latter phases of the Bretton Woods system, was known as the problem of confidence and that focuses on the uneasy symbiosis of dollar, gold, and the SDR. Today, the problem could take the form of how to deal with shifts by the private market and central banks among reserve currencies as they observe changes in the relative attractiveness of these assets. As I noted earlier, this has already given rise to reserve diversification on the part of some central banks. No doubt it has given rise also to diversification of corporate liquidity balances on the part of some large multi-national firms. One is bound to wonder whether extension of this system will not give rise to mounting problems of international instability as profit-oriented investment managers take hold increasingly of the management of international balances.

Yet such efforts to benefit from currency fluctuations in the end are likely to be self-defeating for the participants while causing damage to all. Perhaps I may be permitted to draw a parallel with the experience of U.S. stock market investors. In the late 1960's, "performance" became the rage in the stock market. So-called "performance" or "go-go" mutual investment funds began to dominate the scene. Gradually it became apparent, however, that in the nature of the market there is no reliable way of doing better than the market. All available information is instantly incorporated into stock prices; there are never any clearly over- or under-valued stocks and the market is what mathematicians call a "random walk." The subsequent experience of the stock market was that it became dominated by professional operators, became very jumpy, uncomfortable for most participants, and

eventually altogether lost the favor of investors. Today all the smart security analysts are buying bonds. I hope that no analogous experience is ahead for the foreign exchange market.

The stock market experience showing that there was no way of consistently doing better than the market except by accident produced a very interesting development within the market itself. It was recognized that to minimize risk, at a given rate of return, required maximum diversification. Thus, the best policy for an investor might be to distribute his holdings in accordance with a broad-based stock market index and to forego the questionable benefits of expensive analysis of individual securities. In this way, "index funds" were born and have had a modest vogue. One could visualize a similar development in the exchange market. Instead of trying to shift from one currency into another in hope of catching those that appreciate, the manager of an exchange portfolio might simply diversify using a principle similar to that of an index fund. In the foreign exchange field, two well-known index funds already exist -- their names are SDR and ECU. These "baskets," to return to the language of the foreign exchange market, provide built-in diversification according to fixed ratios. They eliminate the problems, for the world community, of shifts among reserve currencies. The experience of the stock market suggests that, after initial attempts to do better than the market, an investor may sensibly arrive at a fairly stable distribution of his portfolio. We might find ourselves moving in the same direction in the exchange market, perhaps after extensive and painful experience in vainly trying to do better by shifting around. Might it not be better to move to an index-based

system more expeditiously than by moving there via a multi-reserve-currency system?

I raise the question without feeling at all sure of the answer. Nor, equally importantly, would I know how the world could shift to an SDR or ECU system instead of continuing its present drift toward a multi-currency system. I shall pursue the question in terms of the SDR, since that provides broader diversification and since the ECU is already anchored in the reserves of the countries participating in the European Monetary System. I suspect that an SDR system is preferable to a multi-currency system, provided the SDR is sufficiently attractive and inspires sufficient confidence. To date, we have had relatively little experience with it. Would countries commit substantial proportions of their reserves to an abstraction such as this unit? Or would they prefer the concreteness of individual currencies? Only experience can tell, and I hope it will not be a painful experience.

It should be noted that an SDR-based system can function without large-scale SDR issues by the International Monetary Fund. It could function, for instance, on the basis of SDR-denominated liabilities issued by the central banks of those countries whose currencies today are candidates for reserve currency status and who prefer to avoid this distinction. Such SDR denominated liabilities would have to be redeemable on demand against a national currency, though not against reserve assets, if the monetary authority owning the SDR claim wanted to use that national currency for intervention. In that way, such a national currency would not be a reserve currency, even though it served as an intervention currency. The monetary authorities owning the SDR claim would have an SDR risk instead of a risk

in the foreign currency. The central bank issuing the SDR claim would have an SDR risk too, but, the SDR being a basket of national currencies, the likely range of fluctuations would always be less than that of any single national currency. The necessary legal powers, of course, would have to be established, and interest rates and other features would have to be market oriented and competitive.

A more immediately viable means of moving the SDR closer to the center of the international monetary system -- where it belongs by common understanding expressed in the Articles of Agreement of the International Monetary Fund -- would be a Substitution Account in the International Monetary Fund. A Substitution Account is more than a solution in search of a problem, as has sometimes been alleged. The problem is how to promote the role of the SDR. A Substitution Account provides such an opportunity. It deserves careful study, therefore, which it is receiving in the IMF. From what I have said it should be clear that the establishment of a Substitution Account in the IMF, that would receive dollars and issue SDR claims on the Account backed by those dollars, must be conceived as a means of long-run improvement of the international monetary system. In that sense, a gradual substitution of SDRs for dollars may meet the purposes of the participating countries, including of the United States. It should not be conceived or designed as a means for dealing with the immediate international condition of the dollar.

The Euro-markets

No talk about the international monetary scene today would be complete without some reference to the Euro-markets. Of late, I believe, there has been an improved understanding of the role of these markets,

especially the Euro-dollar market. We are not dealing here with magnitudes in the many hundreds of billions of dollars. Those statistics are the result of adding up inter-bank deposits, both within and outside the area of the market. Monetary liabilities of the market after excluding all inter-bank deposits and excluding also all those deposits that are already counted as part of some national money supply, such as the German money supply, are of the order of a little over \$100 billion.

Nor are the Euro-markets "out of control," as has sometimes been alleged. They are controlled, in a monetary sense, by the interest rate prevailing in the Euro-market for each currency, the level of which may encourage or discourage borrowing. That interest rate, in turn, is tied to the interest rate in the home country, through arbitrage, provided that there is freedom of capital movements between the Euro-market and the home market. In the Euro-dollar market, for instance, the interest rate has closely matched the corresponding certificate of deposit rate in the United States ever since controls over the outflow of bank funds were eliminated in 1974 and the aftermath of the Herstatt failure had been overcome. Where, as in the case of the Federal Republic of Germany and Switzerland, as well as many other countries, there are controls over flows from or to the respective Euro-market, this interest rate link will be weaker. On the other hand, it is wrong to say that the Euro-markets do not "create" money and credit but merely intermediate flows that otherwise would take place in equal magnitude through national channels. For the dollar, the proof of that pudding is very simple. If we consolidate the balance sheet of the Euro-dollar market with the balance

sheet of the domestic U.S. banking system, by adding together the respective deposits and assets, the combined deposit volume and credit volume would, of course, be considerably larger than that existing today in the United States. In particular, the volume of deposits would be larger than could be sustained by existing reserves supplied to the market by the Federal Reserve. That volume of reserves, therefore, could not have come into existence given the policies that the Federal Reserve has pursued with respect to money and credit. To make possible the creation of a volume of deposits equal to the combined deposits of the Euro-market and the domestic U.S. banking system, the Federal Reserve would have had to pursue a considerably more expansionary reserve policy than it actually had. The Euro-market has, therefore, in some measure, "created" money and credit outside the control of the Federal Reserve and has thereby increased the total volume of dollar assets and liabilities in the world, although not by an exorbitant amount.

Much the same situation, broadly speaking, exists for the Federal Republic with respect to the Euro-market, which for the D-mark is in good part located in Luxembourg. There is some expansion of D-mark money and credit outside the immediate control of the Bundesbank. The reserves that the Bundesbank has supplied to sustain the deposits of the German banking system would not be sufficient if the D-mark liabilities of the Luxembourg banking system were added to those of the German banking system.

Both the United States and the Federal Republic have open to them the same opportunity of "controlling" the creation of money and credit in their currency. They can slow the expansion of money and credit in the domestic market, over which they have control. This will raise

interest rates in the domestic market and, given a well-functioning link to the Euro-market, interest rates there, too. Then the combined expansion of the two markets can proceed at whatever the monetary authorities regard as the appropriate rate.

The trouble with this solution is that it compels the monetary authorities to slow down disproportionately the growth of credit in the domestic market. The Euro-component, while it will also be slowed by higher interest rates, will still be expanding faster than the total market. This is hard on the domestic economy, and particularly on domestic borrowers who have no access to the Euro-market. On the other hand, if the monetary authorities focus only on the domestic market, as they have done so far, ignoring the expansion in their currency going on in the Euro-market, they would be facilitating more expansionary and perhaps inflationary conditions than they intended or are even aware of. Over time, as the Euro-component of the total market for any currency expands, control over the aggregate volume of money and credit may altogether slip from their hands under these circumstances.

Several remedies are available. One would be to equalize competitive conditions between the Euro and the domestic sections of the market. This could be done, to an approximation, by removing the competitive advantage bestowed on the Euro-market by the absence of reserve requirements. Reserve requirements could be established on Euro-currencies. Alternatively, they could be removed on comparable deposit liabilities of U.S. banks, i.e., large time deposits of all maturities. A second approach would be to impose special restraints upon the expansion of the Euro-market, by subjecting deposits or loans to some relation to capital.

The restraint would have to apply to the Euro-market and not the domestic market, since an overall ratio would allow each bank to continue expanding in the Euro-market at the expense of its domestic business. Liquidity ratios, limiting liabilities to some ratio of liquid assets, could also be considered as a means of controlling this market.

It is by no means certain that even adequate controls over Euro-banking will be able to prevent over-expansion in other sectors of the Euro-markets. Financiers have proved inventive in designing new instruments that could escape the reach of existing controls. A market for loans outside the banks, perhaps with bank cooperation, could develop in short-term assets such as commercial paper, as it already exists in Euro-bonds. The monetary authorities could always control aggregate credit expansion by raising the interest rate, which would affect all markets. But the dilemma posed by differential rates of expansion in the domestic and the Euro-markets might remain. Ultimately, this might then lead to controls over the movement of capital in order to cope with such developments.

The world, and in particular the Federal Republic of Germany and the United States, has a great interest in the maintaining of free international capital markets. It is important, therefore, to develop techniques that will keep the expansion of the Euro-markets manageable, without placing domestic markets at a disadvantage and without recourse to controls.