Research Department
Federal Reserve
Bank of
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FRB SF Weekly Letter

DM-denominated Securities?

February's foreign-trade figures, released last week, proved to be even more disappointing than usual, and immediately the pressures increased on the U.S. government to take steps to remedy the situation. According to many experts—including former Fed chairman Arthur Burns—one way the government could ameliorate the resulting downward pressure on the dollar would be to issue foreign-currency denominated securities. It's worthwhile to consider the pros and cons of this proposal, but first we should look at the reasons for the exchange-market problems now confronting the nation.

Basic reserve asset

The dollar is the basic reserve asset of the international economic system. Because of their confidence in the U.S. economy and in the stability, convenience and security of the U.S. currency, world traders over the years have transacted much of their trade in dollars, and have held dollar assets in order to finance this trade. In addition, investors worldwide have held dollar assets as a significant share of their international portfolio, again because of their confidence in the currency.

Foreigners have been willing, in the process of expanding their dollar assets, to sell to the U.S. more goods, services and long-term financial assets than the U.S. has sold to them. This type of exchange has been perfectly reasonable. Foreigners like the liquidity, convenience, and security of dollar-denominated securities. At the same time, Americans have had the opportunity to diversify their productive facilities by buying and building factories abroad. In a very real sense, the U.S. has acted like a financial intermediary, "borrowing" short and "lending" long.

Still, these foreign dollar holdings represent a potential problem for the system in the event of a sudden reduction in the desire of investors to hold dollar-denominated assets—just as has occurred in the past six months or so. At such times, the run on dollars creates a situation similar to the liquidity problems faced by a financial institution. The difference is that the U.S. cannot "call back" its long-term investments to pay off the short-term debt foreigners wish to relinquish—as a domestic financial institution can. Again, there is no world central bank to insure the supply of liquidity—as there is in the case of a domestic run on banks. The dollar assets are ensconced in the system, and the exchange value of the dollar must adjust downward until investors are again willing to hold such assets.

Benefits of scheme

Given this background, what would be the costs and benefits of having the Treasury issue foreign-currency denominated bonds? Indeed, why would changing the currency denomination of U.S. government debt change anything? The answer, primarily, is that such a step would reduce the volatility of exchange rates.

As discussed in the *Weekly Letter* of February 24, two different forces tend to operate on U.S. exchange rates. One factor, common to all countries, is the effect on exchange rates of differential rates of inflation in different countries. If the U.S. inflates 3 percent faster than Germany, the exchange value of the dollar would tend to fall approximately 3 percent per year

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against the deutschemark, or the U.S. would not remain competitive in international trade. But a second factor, specific to any country whose assets are widely held abroad, is an additional international supply and demand for dollars. Changes in that source of demand can be sharp and sudden as individuals shift their portfolio preferences away from the dollar. These changes can cause correspondingly sharp and sudden movements in the exchange value of the dollar as private foreigners attempt to reduce their dollar holdings and to increase, say, their deutschemark holdings. Thus, the exchange value of the dollar can fluctuate widely around its underlying commodity value determined by relative national inflation rates. In such a situation, importers throughout the world might demand government protection, which would have the effect of hampering the free flow of world trade.

If the government sold deutschemark or other foreign-currency bonds for dollars, it would allow market participants to adjust their portfolios out of dollars without being forced to sell them in the exchange market. The government would take out of the market an asset in excess supply — dollars — and inject an asset in excess demand — DM bonds — completely in line with the market's shift in preferences. Because the government would accommodate the shift in demand for DM relative to dollars by changing the outstanding amounts of these assets, the exchange rate need not adjust so much to equilibrate demand and supply.

An issue of DM-denominated U.S. debt thus would remove a transitory but important pressure from the foreign-exchange market. Because exchange rates would not have to adjust so much to accommodate shifts in asset demand, they would be able to move more in line with the relative commodity value of the dollar.

What's more, such a bond issue needn't be used as a source of funds for intervention in the foreign exchange market. The government could auction the DM issue off to the highest *dollar* bidder. These dollar revenues could then be used to retire existing dollar debt; the net effect would be a trade of deutschemark for dollar U.S. government debt. This would allow exchange rates to move for reasons other than shifts in portfolio preferences. In addition, such a sale of DM securities need not affect the domestic money supply in the U.S. or Germany, provided the securities were sold to the private market rather than to central banks. The debt issue could be used to affect money supplies, or to intervene in exchange markets, but this would be a separate policy decision, and would not be intrinsically related to the bond issue itself.

From a marketing standpoint, such a bond issue should be well received. There are few alternatives outside the U.S. for assets with low default risk and low political risk. American and foreign firms have for some time issued debt denominated in yen or deutschemark, but these instruments are only as reliable as the corporations that sell them. With a U.S.-govern-

ment security denominated in a foreign currency, investors could diversify their portfolios against exchange-rate changes and still maintain the convertibility and security of an asset backed by the U.S. government.

Drawbacks

What are the drawbacks to such a proposal? Basically, the action would do nothing to correct the fundamentals that have caused the decline of the dollar. Thus, rapid inflation in the U.S. would still cause the exchange value of the dollar to decline. A foreign-currency bond issue would serve only to mitigate the short-run problem – and in particular, it would do nothing to improve the trade deficit. Indeed, the respite granted to the exchange markets by such a step might only tempt policymakers to delay the corrective actions required.

In addition, when the government issues debt in foreign currencies, it subjects itself to exchange risk. Further depreciation of the dollar thus would raise the dollar burden of servicing and redeeming government debt, thereby imposing capital losses on government operations and ultimately the U.S. taxpayer. These losses could be a source of embarrassment to government officials as well as a drain on the budget. In such a situation, officials might be more disposed to intervene on a large scale in order to minimize realized exchange losses on debt. In fact, they might be tempted to do so even when a dollar decline seemed necessary for economic reasons.

Again, a very large bond issue might be necessary in order to have the intended beneficial effects. Given the stock of dollar assets outstanding, the necessary bond issue might create an impractically large amount of exchange risk for the government. A $20-billion issue would seem manageable, but a $200-billion issue certainly would not. Given the ease with which most citizens of the world deal in U.S. government securities, as opposed to the vagaries of the exchange market, the demand for DM assets may be significantly higher as a result of the issue than it otherwise would be. In this respect, foreign-government intervention in the exchange market amounted to about $30 billion in the final quarter of 1977, yet these efforts were unsuccessful in propping up the dollar. It's an open question, then, just how large a bond issue would be necessary in such an instance.

In summary, a government issue of foreign-currency bonds could have a significant impact on the exchange markets. By mitigating the exchange-rate effects of adjustments in the foreign demand for dollar assets, it would remove some of the costs of adjustment facing exporters and importers, and thus reduce political pressures for greater protectionism. Still, if such measures were undertaken every time the dollar came under attack, they could degenerate into little more than a sophisticated form of exchange-market intervention. And because the fundamental problems – inflation and inflation expectations – remain unaddressed, policymakers should adopt this line of approach only with considerable caution.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/29/78	Change from 3/22/78	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	108,567	+ 629	+ 13,905	+ 14.69
Loans (gross, adjusted) — total	85,403	+ 631	+ 13,616	+ 18.97
Security loans	1,870	+ 39	+ 403	+ 27.47
Commercial and industrial	26,207	+ 68	+ 2,832	+ 12.12
Real estate	28,825	+ 105	+ 6,462	+ 28.90
Consumer instalment	15,171	+ 90	+ 2,697	+ 21.62
U.S. Treasury securities	8,710	− 8	− 1,265	− 12.68
Other securities	14,454	+ 6	+ 1,554	+ 12.05
Deposits (less cash items) — total*	107,141	+ 1,718	+ 12,184	+ 12.83
Demand deposits (adjusted)	29,634	+ 1,105	+ 2,744	+ 10.20
U.S. Government deposits	548	+ 173	+ 360	+ 191.49
Time deposits — total*	75,305	+ 436	+ 9,282	+ 14.06
States and political subdivisions	6,397	− 47	+ 1,111	+ 21.02
Savings deposits	32,018	+ 283	− 270	− 0.84
Other time deposits‡	34,036	+ 144	+ 7,668	+ 29.08
Large negotiable CD's	15,891	+ 234	+ 6,271	+ 65.19

Weekly Averages of Daily Figures	Week ended 12/21/77	Week ended 12/14/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 14	+ 63	+ 48
Borrowings	31	13	1
Net free(+)/Net borrowed (−)	− 17	+ 50	+ 47
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	− 508	+ 432	− 740
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 374	+ 110	+ 121

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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