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# No Solution for International Monetary Problems

by Dieter Gehrman, Frankfurt\*

At its 14th meeting (in Hamburg) the Interim Committee of the International Monetary Fund (IMF) held further discussions on the establishment of a substitution account through which the monetary authorities would voluntarily transfer a part of their dollar reserves<sup>1</sup> to the IMF in return for interest-bearing claims denominated in Special Drawing Rights (SDR)<sup>2</sup>. The transferred dollars would be invested by the Fund long-term<sup>3</sup> in US Government securities so that they would be withdrawn from international circulation. As was to be expected, the meeting did not yet bring an accord. Technical difficulties were stated to be the reason for this but at this juncture no state seems to be especially interested in setting up such an account.

If the substitution account is to be more than a gesture demonstrating a will to carry out reforms but lacking material content, it must be given attractive features. This is essential in order to ensure its general acceptability and a large enough intake of dollars to give the account credibility. High interest rates, guarantees against depreciation and arrangements to make the SDRs speedily mobilizable can make the substitution account attractive to depositors. The higher the rate of interest, however, the greater is the danger that the interest which the Fund has to pay<sup>4</sup> will not be covered by the receipts of interest on the dollar investment and losses will be incurred.

It was this problem, apart from the question how capital losses from dollar devaluations in terms of SDRs are to be contained, which remained one of the most insuperable obstacles at the Hamburg meeting. The USA showed little inclination to cover the account against possible losses by agreeing to a value-safeguarding clause. It was therefore proposed that part of the IMF gold holdings should be used to guarantee the stability of the value of the substitution account<sup>5</sup>. Among the industrialized states at least this would seem at present to be politically the easiest way of achieving an equitable distribution of the costs and benefits of the account as demanded in Belgrade.

The developing countries however refused to assent to this solution unless the industrialized states made concessions to them in response to their demands for greater voting rights in the IMF and for more and cheaper international liquidity. The "link" still features in the catalogue of demands by the developing countries in the field of monetary policy. The

industrialized states however have rejected the demands of the developing countries because of the resultant inflationary dangers, so that the idea of a substitution account, though not yet officially buried, has been deferred to an indefinite date in the future.

The mobilizability of the claims would have had to be safeguarded by a designation procedure for it would have been a denial of the underlying idea of the substitution account – the permanent sterilization of dollar accounts – if the Fund were to make required financial means available as and when needed. The number of countries eligible for designation would however, in view of the international balance of payments situation, become smaller and smaller. Even the OPEC states, the only important group of states which could have provided international liquidity without running into problems, cannot be expected to be particularly interested in accumulating SDR-denominated claims.

For a while there was talk of creating a secondary market in which private investors could, after a run-in

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<sup>1</sup> At a later stage non-dollar currencies may possibly also be paid into the account. For the time being however only dollar deposits are being considered.

<sup>2</sup> This category of SDRs resembles those used in the IMF but they are not Special Drawing Rights in the technical-legal meaning of the IMF articles (SDRs in the meaning of an allocation procedure). The IMF should not repeat the mistake of the European Communities (EC) and make use of different units of account. Different terms (interest, safeguards against depreciation) can give rise to undesirable conversion transactions.

<sup>3</sup> It is actually intended to invest in undated securities as the account is to be a permanent institution.

<sup>4</sup> Envisaged is a weighted average of interest rates in the markets of important industrialized countries.

<sup>5</sup> Obviously the Fund has thereby departed from the policy of demonetizing gold to which it adhered until now. If the substitution account were successful, a gold guarantee would mean that the world's monetary system is based on a gold-SDR standard.

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period, have acquired and traded in SDR accounts. This would have been a possible way of enhancing the liquidity of the SDR claims but to go by the experience to date with international loans denominated in any kind of account units private investors are very reluctant to make use of capital investment. As a rule they prefer lending in a strong currency to lending in a basket of strong as well as weak currencies. Concepts involving baskets of currencies seem to them often too complicated and not flexible enough, apart from offering hardly any opportunities for speculation or hedging. The SDR claims would presumably not have enjoyed a very high degree of liquidity.

The advocates of the substitution account idea may regret the failure of this reform scheme but there are considerable doubts in principle whether the substitution account can make the expected contribution to the stabilization of the international monetary system at all. It was intended to accomplish the following tasks:

- ☐ Removal of the so-called dollar overhang;
- ☐ Replacement of the dollar as the major reserve medium by Special Drawing Rights and, as a consequence, improvement of the IMF's ability to keep an eye on balance of payments adjustments by its member states;
- ☐ Containment of the trend towards multiple-market diversification of reserves so as to prevent the emergence of an uncontrolled multiple-currency reserve system.

#### **Misleading Dollar Overhang**

The mere demand for a removal of the so-called dollar overhang is already giving rise to errors and misunderstandings. To start with, it is not clear what "dollar overhang" means, by what yardstick it is to be measured and of what magnitude its reduction will have to be in order to ease the pressure on the dollar and to stabilize the international monetary system. Underlying the notion of a dollar overhang is evidently the view that the dollar accounts are in part held unwillingly or reluctantly. But this can normally only be true of central banks which by increasing their dollar reserves for certain reasons want to keep their currencies from appreciating. It is a matter of interpretation to what extent this can be regarded as an involuntary retention of dollars. The crucial question is whether a permanent dollar overhang, quantifiable in absolute terms, exists at all.

In the light of the experience of the first oil crisis in late 1973 and of the very large amounts of foreign

exchange again required for the settlement of oil bills at the present time it is not possible to answer this question, at least not unequivocally<sup>6</sup>. The dollar overhang seems to be a reflection of questions bearing on liquidity distribution and preferences by dollar holders for certain investment forms at certain times and in certain situations rather than an absolutely quantifiable problem. The Federal Republic of Germany may serve as an example to illustrate this point. Its first current account deficit since 1965, combined with a short-term rise of the dollar rate due to a very high interest differential in favour of the dollar, led to capital outflows and a decline of the foreign exchange reserves of the *Deutsche Bundesbank* which provoked frantic reactions and gloomy comments. All of a sudden the large foreign currency reserves of the *Bundesbank* had lost much of their appeal as a cushion promising assurance.

#### **No Dollar Stabilization**

A sterilization of dollar reserves through the establishment of a substitution account would have directly benefited only the central banks which regard their dollar holdings as too high and are looking for more attractive investment opportunities for a part of these holdings. The countries which want to acquire dollars – and they are in a majority – would derive no advantages, to start with. On the contrary, they would have reason to fear that dollars which would in the absence of a substitution account presumably have found their way into the US banking system or onto the Eurodollar market would no longer be available to them as a potential source of credit. The stance of the developing countries – consent to the establishment of the substitution account only on condition of easier access to IMF loans – must be judged with this aspect in view.

The substitution account would be of no profit to the countries which want dollars unless it made a real contribution to the stabilization of the dollar. If it did, their reserves would be protected against depreciation and they would be able to borrow dollars on relatively more favourable terms provided that they can eliminate the exchange rate risk by "staying in dollars".

One need not be too much of a pessimist to hold the view that transfer of dollar accounts to the substitution account will do nothing of significance for the stabilization of the dollar. As long as the dollar plays

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<sup>6</sup> Identification of the Eurodollar market with the dollar overhang is tantamount to a misunderstanding of the function of the Euromarkets as an investment alternative and as a turn-table for international liquidity allowing the surpluses and deficits of different countries to be balanced.

the dominant part in trade and payments transactions and in the international foreign exchange and financial markets, a sterilization of a part<sup>7</sup> of the official dollar reserves is most unlikely to prevent destabilizing switches between foreign currencies being undertaken when market opportunities can be exploited or currency losses have to be avoided. Even short-term changes in the terms of foreign trade payments may trigger shifts in the foreign exchanges capable of causing difficulties to any currency. It is impossible to achieve monetary stability by the institutional exchange of one reserve asset for another. It can only be achieved by an economic policy which engenders trust and convinces the market that the world's major currency is once again capable of exercising its function as a store of value.

On the other hand, if the substitution account is regarded as a facility for easing the distribution problem and specifically the recycling of the financial surpluses of the OPEC states – and this is a view which seems to be gaining more and more ground – the account will have to be fitted out differently. For this purpose it will have to match the investment requirements of the oil states, and the deposited dollars must not be put in US securities but must be put at the disposal of the IMF for balance of payments loan assistance. This however does not solve the problems involved in covering interest shortfalls and capital losses of the account. In the light of the experience gathered in Hamburg it seems unlikely that these problems will be resolved in the near future in a way that is acceptable to all IMF members. Other distribution mechanisms will therefore be needed for the recycling of the petrodollars.

#### **No Chance for Reforming Idea**

The second aim of the substitution account – replacement of the dollar by SDRs as the principal reserve medium – can only be considered in the very long term. It corresponds essentially to the old reforming idea of providing the world with international liquidity according to rational criteria and not letting it to be determined by the economic and foreign policy of the USA. The realization of this idea rests on the presupposition that it is possible to ascertain what amount of international liquidity is required to allow a process of balance of payments adjustments to operate efficiently concurrently with high growth and stable prices.

Apart from the attendant theoretical problems, it is most unlikely that the IMF is able to keep the supply and demand of international liquidity in balance. The functions which its member states want the Fund to fulfil are too diverse. While some of the industrialized states take the view that there is too much international liquidity already, the developing countries demanded in Hamburg once more that they should be given larger quotas and bigger SDR allocations. Given the existing differences of interests between industrialized and developing countries, the creation of international liquidity could hardly be based on rational criteria. It would be a political process in which questions bearing on the financing of development and the general distribution of powers in the IMF are likely to play a greater role than the problems of balance of payments adjustment and international liquidity management.

Laying the indicated political difficulties aside, a monetary order with the SDR as the principal reserve medium would require an international agreement under which the central banks would hold national currencies only within the limits of "working balances". The IMF would thus determine the portfolio management of the national monetary authorities.

Moreover, the Fund would have to have power of surveillance over the accumulation of reserves from other sources so as to be able to direct the adjustment process. This applies to both, the supply side and the demand side. On the supply side the central banks of the major industrialized states have of late again made increasing efforts to exercise control over the Euromarket lendings. This prompted the developing countries to warn in Hamburg against interference with the Euromarkets. They are afraid of seeing their access to a very substantial source of finance being obstructed.

It can certainly not be denied that the recycling of financial surpluses through the Euromarkets has become increasingly difficult. But it is equally undeniable that these markets cannot continue to fulfil efficiently the function of intermediary in the world-wide conveyance of financial resources if they are not allowed to go on operating by and large without state interference. Control on the demand side, which means over the borrowing for balance of payments purposes by IMF member states, is probably politically impracticable because many states would consider it an improper encroachment on their sovereignty. The deficit countries are those which look on the possibility of obtaining requisite finance without much formality and without economic stipulations as a decisive

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<sup>7</sup> An amount of SDR 20 bn was considered to begin with. Eventually the substitution account is to hold SDR 50 bn. This would be about 20 % of the world's foreign exchange reserves and just under 6 % of the Euro-money market volume.

advantage of the Euromarkets. It is therefore very unlikely that the Fund will provide better liquidity control in the future. The dollar will remain the major reserve currency and its replacement by the SDR is a reforming idea without a chance of becoming a reality.

### **No Substitute for Currency Diversification**

The substitution account was supposed to be a means of preventing the diversification of currency reserves over various markets<sup>8</sup>. A process of this kind has been in evidence since the beginning of the seventies when the dollar lost more and more of the confidence originally placed in it and other currencies, like the Japanese yen, Swiss franc, Dutch guilder and Deutschemark, were held on a larger scale. The global figures show in fact that the dollar's share of the total foreign exchange reserves has remained relatively stable at around 80 % but this says nothing about the large amounts of currencies switched between central banks. Developing countries and smaller industrialized states are holding fewer dollars and larger amounts of other national currencies. The major industrialized states on the other hand have been increasing their dollar reserves because their portfolio management has already been to some extent circumscribed by international agreements.

The main opponents of a diversification of the currency reserves are the countries the currencies of which have had to adopt involuntarily the role of a reserve currency. Their essential arguments against diversification are that it impairs their autonomy in the sphere of economic policy and multiplies the difficulties in the international monetary system through destabilizing capital movements and uncontrolled increase of international liquidity.

A consideration of the question whether the SDRs could have effectively prevented the currency diversification leads to a negative answer. As seen by

<sup>8</sup> Cf. Klaus Boeck, Dieter Gehrman: Die DM als internationale Reservewährung (The Deutschemark as an international reserve currency), Hamburg 1974; Deutsche Bundesbank: Monatsbericht, 31st year (1979), No. 11, p. 26ff.

the states which have gone farthest in diversifying the alternative is not: dollars or SDRs but: strong national currencies or SDRs. Bearing in mind that currency reserves are maintained chiefly in order to safeguard the international solvency of a country, it is only rational that central banks adjust their reserve portfolio to the pattern of their country's foreign trade. For a country with strong external economic ties with the Federal Republic of Germany for instance the Deutschemark satisfies the requirements of a reserve currency – high liquidity and stability – better than SDRs, especially if a major proportion of its imports has to be paid for in DM. Considering that over 80 % of the export business of the Federal Republic is invoiced in DM and that its exports account for a good 12 % of the world's export trade it is not surprising that about 11 % of the global foreign currency reserves are held in Deutschemark. The substitution account thus seems to be of interest only to the countries which would like to diversify out of dollars but are prevented by international arrangements from doing so. The exchange of their dollars into SDRs would have made no contribution to the checking of the currency diversification, the more so as the countries which diversify their reserves into different currencies would have been unable to neutralize reserves.

In the light of recent experience with the substitution account the responsible authorities in the sphere of monetary policy should concentrate on the question how the monetary system as it evolves in the market can be put in a frame which is consonant with the rules of free movement of capital. Such diversification of reserves as is desired might for instance be carried out more smoothly and above all in a more controlled manner by means of arrangements between the central banks. Moreover, it is not certain that a monetary system based on several reserve currencies will be more unstable once the desired portfolio mix has been attained than a system with one dominant currency. In any case, it can be said with a high degree of probability that the substitution account is only a technical variant and not a solution for the international monetary problems.

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