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Flexible Exchange Rates
Local Government Expenditures
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Flexible Exchange Rates

Proposals for international monetary reform fall into two categories: those aimed at shoring up the present international monetary system and those aimed at a fundamental change in the nature of the system. Most of the official emphasis in recent years has been on supplementing the existing system, primarily by providing additional liquidity and credit facilities for financing international deficits.

Concern over the adequacy of international liquidity has led to two general increases in the quotas of the International Monetary Fund since its inception, and a third increase is in prospect for next year. The IMF's lending potential was further enhanced in 1962 by the General Arrangements to Borrow, under which the Group-of-Ten nations stand ready to lend the Fund up to $6 billion if needed. The Group-of-Ten recently agreed to extend this line of credit through 1975. Another provision for international liquidity initiated in 1962 is the network of reciprocal currency or "swap" arrangements. These standby agreements provide for the mutual exchange of currencies between two countries, with the international reserves thus created used by one or both countries to defend existing exchange rates against balance of payments pressures.

The most recent and fundamental step in providing for adequate growth in world liquidity is the facility for Special Drawing Rights finally adopted in 1969 after several years of study and negotiation. SDRs are intended to supplement existing reserve assets as a means of financing external deficits. They are to serve the same general role as official gold does presently, as their nickname, "paper gold," suggests.

Many economists believe, however, that while additional liquidity may be desirable, the more urgent need is for an improved international adjustment mechanism to correct deficits. According to this view, trying to solve current international ills with more and more liquidity is like trying to solve family financial problems by getting another credit card. To the extent that the adjustment mechanism corrects deficits, the need for liquidity is lessened.

The approach to reform reviewed here involves a greater degree of flexibility of foreign exchange rates. Flexibile exchange rates have long been advocated by a large segment of the academic community, and recently the idea of greater exchange rate flexibility has received increased attention in "official" circles. The Subcommittee on International Exchange and Payments of the Joint Economic Committee of Congress has urged the International Monetary Fund to study the possibility of greater exchange rate flexibility within its present framework. Several of the official delegates to the recent IMF meetings, including Secretary of the Treasury Kennedy, called for official study of the question. Finally, interest in exchange rate flexibility received new impetus from the recent German decision to allow the mark to float until a new parity was established.

General Principles An exchange rate is simply a price—the price of one currency in terms of another currency. Downward pressure is placed on the exchange rate of a country experiencing a deficit in its balance of payments as its currency is in excess supply in the foreign exchange market. Conversely, upward pressure is placed on the exchange rate of a surplus country since its currency is in excess demand at the existing rate. In perfectly free foreign exchange markets, exchange rates presumably would adjust until international equilibrium is restored.

But foreign exchange markets today are not free markets. Balance of payments pressures on exchange rates are currently offset by official intervention which permits only nominal changes in rates. With exchange rates pegged within a narrow band under the present system, these pressures fall first on the monetary reserves of the countries involved, and the burden of international adjustment falls ultimately on their domestic economies. And the do-

mestic goals of full employment and price stability are sometimes in sharp conflict with the requirements of international equilibrium. Substantial inflation may be required to eliminate an external surplus while unemployment and recession may be necessary to cope with a deficit. The natural reluctance to subject the domestic economy to such harsh external discipline is largely responsible for the increasing reliance on government controls over foreign trade and capital movements.

Proponents of flexible exchange rates argue that their system is the only alternative to nationalistic controls over international trade and investment on the one hand, or wide fluctuations in the domestic economy on the other. Instead of forcing the internal economy to adjust to a predetermined fixed exchange rate, they say we should let the exchange rate itself do the adjusting. Exchange depreciation would normally tend to make a deficit country more competitive internationally by making its exports cheaper abroad and its imports more expensive at home. Exchange appreciation in surplus countries would tend to stimulate imports and depress exports. The idea is simply to extend the free market into the area of international finance. If external payments do not balance at the existing exchange rate, the rate would adjust in the market until equilibrium is restored.

To say that exchange rate adjustment can promote external equilibrium does not mean that the internal economy is left unaffected. Exchange depreciation raises import prices relative to domestic prices and induces a shift in consumption patterns away from imports in favor of domestic goods competing with imports. Labor and other productive resources shift out of domestic production into export industries. Exchange appreciation in a surplus country would shift the patterns of consumption and production in the opposite direction. The underlying shifts in production and consumption patterns necessary to restore equilibrium are thus similar to those required under the present system of fixed rates. The principal difference is that under flexible rates these internal adjustments would respond to changes in the exchange rate rather than to deflation or inflation in domestic prices and money incomes.

Since the underlying adjustments are ideally the same under the two systems, there would seem to be little to recommend a flexible-rate system. Actually many advocates of flexible rates would be just as happy with fixed rates if internal prices and wages were as flexible in both directions as a free market exchange rate. But since prices, and particularly wages, tend to be rigid in a downward direction, the deflation necessary to cure a deficit under a fixed-rate system would exert downward pressure on the employment level. While exchange depreciation is not painless and usually involves a reduction in real income, it presumably would avoid the employment effects of domestic price and wage rigidities. Flexible rates are thus seen as a means of rendering rigid internal prices and wages flexible in terms of foreign currencies.

Even if flexible exchange rates alleviated pressure on employment resulting from downward price and wage rigidity, unemployment could still result from resource immobility. International adjustment through the current account requires a reallocation of resources between domestic and foreign-trade sectors of the economy whether induced by fluctuations in the exchange rate or by fluctuations in the domestic economy. If resources are not sufficiently mobile, unemployment could result under either exchange-rate system. Under flexible rates, however, resource immobility would probably increase the magnitude of exchange-rate adjustment necessary to maintain external balance since it would reduce the sensitivity of output of various sectors of the economy to relative price changes.

Domestic Policy Independence Under a fixed-rate system there is a potential conflict between domestic policy objectives and the requirements of international equilibrium. Such a conflict would be most apparent in the case of a deficit country experiencing a domestic recession. Easy monetary-fiscal policies may well restore domestic prosperity, but at the expense of a worsened external deficit. Policies designed to correct the external deficit would tend to aggravate the recession. In recent years this dilemma has usually resulted in controls over international trade and investment rather than the sacrifice of domestic stabilization objectives.

At the other extreme is the case of a surplus country experiencing internal inflation. Successful efforts to curb the inflation would increase the external surplus while expansionary policies to reduce the surplus would intensify the inflation. This par-

ticular policy dilemma led to the Canadian adoption of flexible exchange rates in 1950; it also led the Germans to revalue the mark in 1961 and again this year.

Proponents of flexible exchange rates argue that their system would reduce or eliminate external constraints on domestic policies. Monetary and fiscal policies could pursue the desired combination of price stability and full employment while exchange-rate adjustments would maintain equilibrium in the balance of payments. Domestic policy could influence the total level of expenditure for domestic stabilization purposes because the exchange rate would be free to adjust to the extent necessary to induce the shifts in consumption and production patterns required for external equilibrium. Hence, in the previous example of a deficit country with an internal recession, expansive policies could raise the total level of output while the resulting exchange depreciation shifts a larger portion of it into export industries. In the case of the surplus country experiencing internal inflation, policy could be tightened to reduce the excessive level of total spending while exchange appreciation increases the portion of total spending going for imports and reduces the portion of total output being exported.

A related advantage often claimed for flexible exchange rates is that they block the international transmission of economic fluctuations commonly associated with fixed-rate systems. In other words, flexible rates are said to insulate the domestic economy from foreign inflationary or deflationary pressures.[1]

A foreign recession may be transmitted to the domestic economy under fixed exchange rates through a decline in export demand and a reduction in the foreign trade balance. In the absence of offsetting influences elsewhere, the reduction in net foreign spending for domestic output means a reduction in total spending, and thus total income. A foreign boom or inflation would increase export demand, improve the balance of trade, and thus raise the levels of total spending, money income, and prices. The Germans in particular have found that this transmission mechanism makes it difficult to maintain price stability in an inflationary world.

Flexible exchange rates may provide a degree of insulation from foreign price and income changes by neutralizing the net effect of a change in export demand on the balance of trade. A foreign recession would still reduce export demand, but exchange depreciation should limit the deterioration of the trade balance. The depreciation would discourage the fall in exports while encouraging a decline in imports. If potentially complicating capital flows could be ignored, exchange depreciation could be expected to prevent any worsening of the trade balance. With no change in *net* foreign spending on domestic output, there should be no imported recession. Conversely, a foreign inflation would increase export demand, but the resulting exchange appreciation would discourage the expansion of exports while encouraging import growth. The appreciation of the currency, which would not be possible under a fixed-rate system, would intercept the imported inflation. Flexible-rate advocates recognize potential complications in this insulation mechanism, especially those arising out of interest-sensitive capital flows; but they still maintain that a nation would have more economic sovereignty under flexible rates than under the present system.

Arguments and Counterarguments Several objections have been raised against the use of flexible exchange rates. The most important, perhaps, is the argument that international traders and investors require the certainty of stable rates to do business. The possibility of loss due to an adverse movement in the exchange rate, it is said, would discourage international trade and investment.

Propenents of flexible rates counter with several arguments. First, they reject any automatic association of free-market rates with unstable rates. They cite other commodities and other markets that enjoy relatively stable prices in the absence of government price fixing. Second, they argue that exchange risks are not entirely absent under the present system, since official par values are sometimes changed abruptly. Third, exchange risks can be hedged in the forward exchange market in much the same way as commodity traders hedge in the commodity futures market. Hedging does involve extra costs, however, and the cost of hedging some important kinds of transactions may be prohibitive. Finally, they maintain that there are all kinds of risks in international trade, and official measures taken to protect a fixed rate may create more problems for traders and investors than would the adjustment

[1] Robert D. McTeer, Jr., "Economic Independence and Insulation through Flexible Exchange Rates," Nicholas A. Beadles and L. Aubrey Drewry, Jr. (eds.), *Money, the Market and the State* (Athens: University of Georgia Press, 1968), pp. 102-133.

they seek to avoid. The risk of exchange fluctuation must be weighed against the alternative risks of controls over trade and investment and other restrictive measures designed to maintain fixed rates. Certainly the cause of international trade and investment has not been advanced by the recent measures taken by several countries, including the United States, to support official exchange parities.

Another argument often heard is that speculation would be destabilizing if rates were flexible—that speculators would take a given change in the rate as a signal for further changes in the same direction and act accordingly. Supporters of flexible rates, on the other hand, argue that the present system is *more* conducive to destabilizing speculation since rates are held rigid while huge deficits pile up. Faced with rates that are clearly out of line with reality, speculators or traders with an uncovered position stand to make large gains if they are right and have little to lose if they are wrong. The events of the past couple of years illustrate the potential for one-way speculation under the present system. On the other hand, it is argued, if rates were determined in the free market, they would presumably adjust gradually to changing economic conditions, and speculators would not be faced with rates that are clearly undervalued or overvalued. The potential gain through speculation would thus be diminished and would be matched by a greater chance of loss.

Another argument against flexible rates is that they would eliminate an important external constraint against inflationary policies. Under fixed rates, it is argued, inflationary policies worsen the balance of payments and lead to a loss of gold or foreign exchange reserves. The reserve loss demands attention and forces the monetary authorities to adopt more restrictive policies. However, policies that would lead to reserve losses under the present system would lead to exchange depreciation if rates were free, and exchange depreciation may also be something to be avoided. It raises import prices and usually worsens the terms of trade. The question is: which provides the greater constraint on inflationary policies—reserve losses or exchange depreciation? While often asked, such a question misses the point that inflation is undesirable in itself and should be avoided, external constraint or not. No international financial system can force responsible domestic policies or substitute for them.

Limited Flexibility The discussion so far has assumed completely free exchange rates to focus on general principles. The near-term prospects for such a system, however, are not good. The world's monetary authorities are understandably reluctant to make such a radical departure from orthodoxy, and do not always have the power to make such changes even if they wished to. Rather, official attention has been directed recently to more limited forms of flexibility that would not break completely with the par value system.

The suggestions for limited flexibility receiving the most attention today involve some version of "wider bands," "crawlings pegs," or a combination of the two. Both these approaches aim at obtaining some of the assumed advantages of exchange flexibility without sacrificing the basic nature of the par value system.

The wider band proposal involves extending the range of permissible exchange rate variation around the par value beyond the present 1% limit sanctioned by the IMF. Presumably, many, though not all, of the advantages (and disadvantages) claimed for flexible exchange rates would apply to a lesser extent to a wider band. In urging official study of this proposal in 1965 the Joint Economic Committee of Congress gave its possible advantages as follows:

> Broadening the limits for exchange rate variations could discourage short-term capital outflows through free market forces, on which we should continue to place our main reliance; permit greater freedom for monetary policy to promote domestic objectives; discourage speculation against currencies by increasing the risk; and to some extent promote equilibrating adjustment in the trade balance through somewhat greater exchange rate variations than are now permitted.[2]

A wider band would represent only a one-shot increase in the ability of the exchange rate to adjust. Divergent national policies still would tend to push rates to their upper or lower support limits, and their ability to adjust in that direction would be "used up." The crawling peg proposal, on the other hand, provides for a gradual, but continuing, adjustment of the par value itself. The speed of adjustment might be determined in advance, say a maximum of one sixth of 1% per month, or it might depend on past market performance. For example, the peg could be set each month or each week at a level equal to the moving average of the actual market rate over a specified time period. Either way, the adjustment over short time periods would be too small, presumably, to make large scale speculation worthwhile.

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[2] *1965 Joint Economic Report*, Report of the Joint Economic Committee on the January 1965 Economic Report of the President, March 17, 1965, p. 15.