

APR 17 1962

The Honorable Paul H. Douglas,
United States Senate,
Washington 25, D. C.

Dear Senator Douglas:

During my appearance before the Joint Economic Committee on January 30, 1962, you raised with me the following question:

"Instead of having fixed exchange rates, why would it not be a good thing for the western world to adopt a fluctuating exchange rate? Then you wouldn't have to worry about your balance of payments or gold reserves. You would have exchange rates fluctuate according to the relative balance of imports and exports, claims and debits, and you would get an automatic adjustment."

After some exchange between us, you requested that the staff of the Board of Governors prepare a memorandum on the subject for the benefit of the Committee.

I am herewith transmitting the requested paper. It was prepared under the general direction of Dr. Ralph A. Young, Adviser to the Board and Director, Division of International Finance. Mr. Robert L. Sammons, Adviser in that Division, had responsibility for sifting and digesting the professional literature which advances a case for a system of flexible exchange rates. Dr. J. Herbert Furth, also Adviser in our Division of International Finance, carried main responsibility for preparing a critical evaluation of the arguments against flexible exchange rates, and by implication expressing the case for fixed exchange rates. The product of their respective analytical work has been merged into a single paper. The case for and against a system of fixed exchange rates was not prepared separately, because the arguments would have been repetitive.

The problems encountered in dealing with the many-sided question you raise are necessarily complex and an answer to it needs to be formulated with care and balance. Consequently, the paper has taken a considerably greater amount of time and effort than either you or I originally planned for it. In view of your long experience as an economic scholar, I know that you fully appreciate the analytical difficulties of the task, which account for the time taken in its preparation.

The Honorable Paul H. Douglas -2-

The nature and purpose of the paper made it necessary to summarize the arguments in terms of their practical applicability, rather than to pursue their theoretical foundations. In any case, rigorous theoretical treatment would have required a much more elaborate and time-consuming effort.

The paper will be studied with interest by the members of the Board of Governors, and will be made available to a broader audience by publication in an early issue of the Federal Reserve Bulletin. But, as you requested, it is submitted strictly as a staff memorandum. Its single objective is to illuminate the issue of flexible vs. fixed rates of foreign exchange as a matter of national policy.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.

Enclosure

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

April 17, 1962

The Honorable Wright Patman,
Chairman, Joint Economic Committee,
Washington 25, D. C.

Dear Mr. Chairman:

During my appearance before the Joint Economic Committee on January 30, 1962, Senator Douglas raised with me the following question:

"Instead of having fixed exchange rates, why would it not be a good thing for the western world to adopt a fluctuating exchange rate? Then you wouldn't have to worry about your balance of payments or gold reserves. You would have exchange rates fluctuate according to the relative balance of imports and exports, claims and debits, and you would get an automatic adjustment."

After some discussion, Senator Douglas requested that the staff of the Board of Governors prepare a memorandum on the subject for the benefit of the Committee.

I am herewith transmitting, for the use of the Committee, twenty copies of the requested paper. It was prepared under the general direction of Dr. Ralph A. Young, Adviser to the Board and Director, Division of International Finance. Mr. Robert L. Sammons, Adviser in that Division, had responsibility for sifting and digesting the professional literature which advances a case for a system of flexible exchange rates. Dr. J. Herbert Furth, also Adviser in our Division of International Finance, carried main responsibility for preparing a critical evaluation of the arguments against flexible exchange rates, and by implication expressing the case for fixed exchange rates. The product of their respective analytical work has been merged into a single paper. The case for and against a system of fixed exchange rates was not prepared separately, because the arguments would have been repetitive.

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I am sending a separate letter to Senator Douglas, together with a copy of the paper.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.,
Chairman.

Enclosures.

A SYSTEM OF FLEXIBLE EXCHANGE RATES: PRO AND CON

Reconstruction of the international payments mechanism following World War II was based, and continues to be based, on a system of fixed par values for all major currencies. The International Monetary Fund, established under the Bretton Woods Agreements of 1944 "to promote international monetary cooperation," was founded on this principle. Any change in the system would have sweeping consequences for international economic relations and through them for the domestic economies of the free world. Nevertheless, advantages and disadvantages of flexible versus fixed rates have continually been discussed inside and outside of academic circles.

Advocates of a system of flexible exchange rates argue that it would provide each major country with a mechanism for prompt and sensitive international payments adjustment. They believe that this mechanism would greatly reduce -- but not entirely eliminate -- the constraints on domestic financial policies imposed by a system of fixed rates of exchange. The adjustments in the balance of payments that would occur under flexible rates would be more efficient and less likely to have adverse side effects than adjustments under a fixed rate system, they contend.

Opponents of a system of flexible exchange rates maintain that the system would have serious disadvantages rather than advantages. They believe that such a system would require more rather than less restrictive domestic financial policies in order to achieve sustained economic progress. Unless countries paid close attention to their balance of international payments, exchange rates would fluctuate violently,

disrupting international commerce and investment. If applied to key currencies, a system of flexible rates would eliminate these currencies as means of international payments and as reserve assets.

According to classical economic theory, a major advantage of the pre-1914 gold standard was that it provided an effective, although slow, mechanism of adjustment for the balance of payments through the fairly direct tie between the amount of a country's gold holdings and its supply of bank credit and money. A country with a balance of payments surplus received gold, its bank credit and money expanded relative to the gold-losing deficit countries, and its money incomes and prices tended to rise. While this adjustment was taking place, an equilibrating movement of short-term capital also tended to occur, because interest rates tended to rise in the deficit countries, thus attracting funds from the surplus countries.

After a time imports in the surplus country would tend to rise and exports to fall; the reverse would take place in deficit countries. Balance in international payments would thus be restored.

Under modern systems of managed currency convertibility, so the argument of the advocates of a system of flexible exchange rates runs, this mechanism of adjustment does not have its former effectiveness because of the tendency of prices and wages to resist downward adjustment. And monetary authorities pursue policies geared to full employment, economic growth, and domestic price stability, while tempering, cushioning, or offsetting balance of payments developments that might frustrate the achievement of domestic stabilization objectives.

This line of reasoning leads to the conclusion that balance of payments equilibrium no longer is brought about by quasi-automatic economic forces, nor is it considered an economic policy aim of first importance. It is taken into account only as a limiting condition of domestic policy that has to be met if a country is to maintain a stable value for its currency in terms of gold and other convertible currencies. In this context, it is argued that a system of flexible exchange rates would offer more freedom to pursue the major domestic goals of economic policy without incurring unduly adverse international effects.

In this paper the mechanism of international adjustment under a system of flexible exchange rates participated in by the major industrial countries, including the United States, is evaluated. First a system of flexible exchange rates free of any official intervention and with no limits as to the possible range of exchange rate fluctuation is described. Then a modified system in which official governmental intervention to temper or limit exchange rate fluctuations would be in operation is considered. Finally, the case against any system of flexible exchange rates is presented. The major premises and arguments of the case for such a system are critically assessed, with special attention to the consequences it would have for the dollar.

The Case for Flexible Exchange Rates

Two assumptions underlie the case for flexible rates: First, that the participating countries will be able to pursue domestic financial policies -- fiscal and monetary -- that sustain high levels of domestic economic activity, balanced economic growth, and relative stability of domestic price levels. Second, that each country in the system will permit others to adjust their balance of payments by changing exchange rates without resorting to exchange controls, to protective trade measures, or to competitive exchange rate adjustment in defending its economy against any unfavorable effects of any changes in the foreign exchange values of other currencies.

The Foreign Exchange Rate as a Price

The theoretical case for the superiority of completely flexible rates over fixed rates rests on simple postulates. The foreign exchange rate is a price that should be permitted to perform the normal functions of a price. Its immediate function should be to balance supply and demand in the foreign currency market. In doing so, it would establish a relation between domestic and foreign prices and costs that would induce longer run changes in the production, investment, and consumption of goods moving in international trade in a way that would foster and maintain balance in external payments.

In any market, there is some price that will clear the market, in the short run. In markets where supply or demand is unresponsive to price change in the short run, price fluctuations may sometimes be more violent than is necessary to restore or maintain long-run equilibrium.

Price changes may also be destabilizing if demand and supply are strongly sensitive to expectations about future influences on the market. Thus, a price decline may reduce demand (and increase supply) if a further decline is anticipated.

The price of foreign exchange differs from the price of a single commodity in that it represents to both buyers and sellers command over a whole basket of goods, services, real capital assets, and claims payable in a foreign or the domestic currency. Thus, the demand or supply of a foreign currency is derived from many specific needs or motivations. As a composite demand or supply, each will be responsive to small changes in price.

Consequently, changes in foreign currency prices under a flexible exchange rate system could be expected to produce relatively prompt adjustment in the supply of and demand for foreign exchange and thus in the balance of payments. If balance of payments adjustment could be achieved under a flexible rate system without interfering with domestic stabilization policies or unduly burdening other trading countries, such a system would have advantages greater than any possible disadvantages attributable to the rate changes themselves.

The Mechanism of Adjustment

The mechanism of adjustment under a system of exchange rates that would be permitted to fluctuate freely, without government limitation or intervention, involves two major types of international transactions -- the movement of goods and services, mainly merchandise, and the movement of capital, mainly short-term. The theoretical effects on merchandise trade will be treated first. For simplicity, the adjustments of a deficit

country will be used as an illustration. (The adjustments necessary for a surplus country under a flexible rate system would be the reverse.)

Unless the governmental authorities supported the rate by selling gold or foreign exchange, a deficit country would find its currency becoming less valuable in relation to other currencies, the demand for it falling relative to the supply of it. What changes in prices would result would be influenced by the elasticities of supply and demand, and by the importance of the deficit country as a world supplier or purchaser of specific commodities. But in general, price movements along the following lines might be expected.

Effects on imports. The prices of the deficit country's imports, in terms of its own currency, would tend to rise. This rise would reduce its purchases of imported goods. How great the reduction would be would depend on the price elasticities of demand for such goods and the elasticities of domestic supply of competitive goods.

The higher prices for import goods would encourage the expansion of domestic production of competitive goods, insofar as domestic goods were substitutable for imports, and thus reduce imports even if total demand for these goods were not reduced by the increase in prices. The rapidity and extent of the response would depend on how widely elasticities varied from commodity to commodity. Elasticities would also vary with the state of the business cycle -- especially with the presence or absence of unutilized capacity in the import-competing industries. Responsiveness to import price changes would be specially affected by the length and complexity of the production process for the competing domestic goods.

If foreign exporters were able and willing to reduce their prices in terms of foreign currencies (maintain their prices in terms of the depreciating currency) in order to keep their import markets, adjustments would be less. But there would still be some reduction in foreign exchange expenditures, even if the quantity of imports did not fall.

Economists differ on whether the effects on imports of exchange depreciation under a flexible rate system would vary from the effects on imports of outright devaluation under a fixed rate system. Expectations about further exchange rate changes would be very different in the two situations, and the effects of the different expectations are difficult to predict. But if one opposes flexible rates on the grounds that they would not affect foreign exchange expenditures on imports, one must also argue that exchange devaluation could never be justified for a similar reason.

Effects on exports. Effects on the exports of the deficit country would depend on the organization and structure of its production and the competitive position of its export products in world markets. For one-product countries facing relatively inelastic demand schedules, especially for principal exporters of the particular commodity, exchange depreciation might reduce the foreign exchange proceeds of exports. But for industrialized countries, with diversified exports competitive with similar products of other industrialized countries, the result would probably be some increase in exports. The increase would be the larger, the greater the underutilization of existing capacity.

The effect on prices of export goods in terms of domestic currency would vary from commodity to commodity. Probably export prices

in terms of domestic currency would rise, on the average, but not by so much as the depreciation in the external value of the currency.

For internationally traded export commodities, the price rise would be inversely proportional, or nearly so, to the reduction in the external value of the currency. For other commodities, the price rise would depend on the relative importance of exports to domestic demand.

If the price rise for export goods fully offset the depreciation in the value of the currency, the effect would be two-fold. Unless the domestic demand for such goods were completely inelastic, the amount sold at home would fall, thus freeing more production for export. It seems reasonable to assume that such an adjustment would come rapidly. But even if it were delayed, profits in the export industries would rise, and enterprises in these industries would bid actively for resources for export production with eventual beneficial effect on the balance of payments.

On the other hand, if the rise in price did not fully offset the depreciation in value of the currency, foreign buyers would enjoy a lower price in terms of their currencies, and domestic producers would thus enjoy an increase in foreign orders. How large the increase would be would depend on whether competitive foreign producers would accept the situation without lowering their own prices. If prices declined all around in international markets, and world demand was price elastic, the total market would expand and the exports of the depreciating country would presumably rise pari passu with such expansion.

The speed of adjustment on the export side would thus depend on (1) the extent of the rise in domestic prices of export goods, (2) the rapidity with which domestic production could be expanded (clearly greater in a recession than in a boom), (3) the elasticity of domestic demand for export goods, and (4) the response of foreign competitors to any reduction of prices in terms of foreign currencies. It seems reasonable to assume, however, that significant marginal adjustments would respond with workable promptness to small changes in exchange rates. Such adjustments might also lead to the exportation of products not previously exported.

The structure of production and foreign trade is constantly changing. Thus data on past effects of exchange rate changes on exports is not particularly helpful in trying to predict what would happen under a generally applicable flexible rate system. Advocates of such a system must generally resort to a priori inductive reasoning and thus must also believe that the price mechanism for goods and services will work through the foreign exchange mechanism, as it does admittedly -- although not always to everyone's satisfaction -- in a domestic market for goods and services.

Countercyclical effects. If a country committed and accustomed to a flexible exchange rate mechanism were to experience a balance of payments deficit and domestic recession simultaneously, depreciation of its currency internationally could result in special advantages. In a recession, the possible effects of depreciation on both exports and imports would tend to stimulate total effective demand at home. Domestic production of import-competing and export goods would be directly stimulated, and purely domestic output would receive a secondary stimulus.

An adverse effect of the currency depreciation would be to alter the terms of international trade -- making it necessary for the deficit

country to give up more of its own output in exchange for a given quantity of imports. The expansion in domestic output induced by the currency depreciation, however, would tend to counter adverse effects on domestic standards of living.

A general system of flexible exchange rates would not automatically result in currency depreciation if a recession of about equal amplitude hit all countries at the same time. In this situation exports and imports would drop in approximately the same proportion. Thus exchange rates would tend to remain unchanged, and the effect of the recession would be the same as it would be under a system of fixed exchange rates.

Effects on capital movements. Even if it be granted that under flexible rates the balance of payments would be adjusted through changes in the trade account, there remains the problem of capital movements. Would not the currency depreciation generate expectations of further depreciation and thus set in motion capital movements that would in themselves produce such further depreciation? Would not this, in turn, lead to unwarranted, unneeded fluctuations in exchange rates and to a loss of confidence in future exchange values with a consequent disruption of the processes of international trade and investment? The proponents of a flexible exchange rate system argue that these consequences would not follow.

Admittedly, volatile capital movements are greatly influenced by psychological and expectational factors. The only experience the world has had with flexible rates has been under an international currency system where flexible rates were the exception rather than the rule. There has always been at least one currency, the dollar, freely convertible into

gold at a fixed rate, except for a brief period in 1933-34. For this reason, it is impossible to guess what might have happened in a world of flexible rates.

If the principal countries promoted a reasonable degree of stability in economic activity and prices, ^{1/} and there were no significant direct controls, wide fluctuations in exchange rates would not be expected to occur. So long as a currency was freely convertible into goods and services for export, at relatively stable prices, it could not depreciate far before it would begin to appear a bargain both to traders and speculators in property values. At this point, some stabilizing speculative trade and capital flows could be expected to set in. If these developments failed to occur, it would be because the speculators distrusted the fiscal and monetary policies of the government or the basic economic forces shaping the internal structure of the economy.

Large flows of volatile speculative capital occur even under the present fixed rate system, notably when a large part of the market believes that a specific exchange rate is overvalued or undervalued and hence cannot be or will not be long maintained. If determination of the exchange rate were left to the market, speculators would have to analyze all the factors entering into the demand for and supply of exchange. Market opinion might then not be nearly so unanimous as it sometimes seems to be at present. Moreover, any movement into a currency would begin immediately to increase the cost of that currency, thus raising the possibility of loss as well as gain in the minds of the speculators.

^{1/} In the absence of such policies, any system of exchange rates -- fixed or flexible -- would tend to break down.

Under a system of fixed exchange rates with narrow spreads, the possibility of loss is present but much less so. If apprehension of risk turned out to be the market reaction, such a response would tend to dampen, and eventually reverse, any speculative movement of funds between international money and capital markets not warranted by relative price changes.

A Modified System of Flexible Rates

Up to now a completely flexible rate system has been discussed. It has been assumed that there would be no intervention in the exchange markets by the authorities, and hence no need for official reserves of gold or foreign currencies. However, such a system is hardly realistic. Proponents of flexible rates usually acknowledge that they would allow for some official intervention to smooth out short-run fluctuations or to provide for some stability in the flow of import payments and other payments to foreigners in the event of unpredictable or unavoidable short-run fluctuations in foreign exchange receipts. Such a modified system of flexible exchange rates would, however, be faced with two problems.

First, what assets would be used as monetary reserves? The key trading countries might want to use only gold, believing gold would be more likely to retain its value in relation to the domestic currency and to the currencies of other industrial countries. However, countries might be willing to hold reserves in other important currencies which have proved stable enough to inspire confidence that this stability would continue. Or if central banks would not hold reserves in foreign currencies as a regular matter, they might still, as a matter of central bank cooperation, engage in reciprocal currency transactions temporarily to enable the participating central banks to intervene in the foreign exchange market in behalf of their currencies.

Second, would not there have to be some rules of the game for official intervention, especially for actions to avoid competitive depreciation?

If these problems could be solved, an international system of modified flexible rates might offer not only the advantages discussed earlier, but also the following advantages:

Changes in Rates vs. Changes in Reserves

With flexible rates, a country could let flows of volatile short-term capital affect the exchange rate instead of affecting its international monetary reserves. Changes in reserves stemming from international capital flows, even if a central bank offsets their impact on domestic credit by open-market operations, may undermine public confidence in the monetary system and consequently upset the credit and exchange markets. As things are, changes in exchange rates within moderate limits might be preferable to changes in reserves.

Management of Reserves

Under a system of flexible exchange rates, the monetary authorities of a country could regulate their reserve holdings on the basis of the economy's financial needs. They could buy or sell gold or foreign exchange (if they continued to hold foreign currency reserves despite exchange risks) whenever they thought it appropriate and advantageous without regard to effects on the exchange rate. However, if the operations were interpreted as official efforts deliberately to depreciate a country's currency, other countries participating in the flexible currency system might retaliate.

Speed of Adjustment

With flexible exchange rates, monetary authorities would not be so tempted to defend an overvalued or undervalued currency and thus delay a necessary rate adjustment. Such delays tend to impair a country's monetary reserves and slow the adaptation of its domestic economy to the requirements of external balance. Under a fixed exchange rate system, the exchange rate becomes a symbol of national prestige. A devaluation is considered as evidence of some failure of the government's economic policy and as a breach of faith with the public. Consequently, devaluing or revaluing a currency in terms of gold and other currencies becomes a last resort, to be resisted as long as possible. Sometimes countries have imposed, or reimposed, or tightened exchange controls rather than devalued the currency. When devaluations or revaluations occur in major countries, they tend to be a disruptive factor in international trade and finance. Under a flexible exchange rate system, if a currency was overvalued or undervalued, depreciation or appreciation of the rate would come soon and, unless there was speculation, would have a chance of being moderate.

Size of Reserves

If a system of flexible exchange rates were universally adopted, many countries could operate with smaller international monetary reserves in gold or foreign currencies than they presently hold. For a country would not have to protect its monetary system against a persistent, large-scale reduction in the volume of its reserves. If exchange rate adjustments could take care of most fluctuations in its balance of payments, more of a country's national wealth could be invested in domestic production rather than in holdings of gold or short-term claims on foreign countries.

Such a change would be particularly important for less developed countries. They would no longer need to grant credit to the United States and the United Kingdom by holding more monetary reserves than they needed for working balances in dollars and in sterling.

The Case Against the System in Either Form

The arguments for a flexible exchange rate system need critical evaluation, particularly on the possible effects on the dollar. Such an evaluation leads to the following main conclusions.

1. The rigidities of the present economic system are not so pervasive that modern economies cannot, within reasonable periods, adjust to temporary disequilibrium in the balance of international payments under a system of fixed exchange rates.

2. A system of flexible exchange rates would not free participating countries from having to watch their balance of payments and monetary reserves. In fact, because of the uncertainties of exchange rate fluctuations and instabilities, they would have to pay more attention to them than under a system of fixed exchange rates.

3. Whatever advantages may be claimed for flexible exchange rates, they would be more than offset by disadvantages if the system were applied to currencies widely used as means of international payments and as international reserve assets.

4. Flexible exchange rates would involve a serious risk that destabilizing forces generated by exchange rate fluctuations would become uncontrollable.

5. Flexible exchange rates would make international trade and investment transactions more uncertain and hence more costly.

6. By impeding the international division of labor, the system would retard economic growth throughout the free world.

7. The limited supply of gold and the risks of keeping monetary reserves in foreign currencies of fluctuating value would hamper the intervention needed to make a modified system of flexible exchange rates workable. Reaching agreement on effective rules of the game would also be difficult.

Role of Economic Rigidities

The contention that the present economic system has become inflexible from cumulating rigidities is exaggerated. Downward adjustment of average prices and wages do encounter resistance. But international imbalance generally arises from price and cost differentials in particular export or import industries. Individual prices and, to a lesser degree, earnings still fluctuate downward as well as upward.

Quite recently, the impact of increased imports on U.S. prices and wages has been important in helping to restore competitiveness in various branches of U.S. industry, in curbing inflationary tendencies, and in strengthening the U.S. balance of trade. This experience shows that there continues to be a powerful mechanism of international payments adjustment under modern convertible currency conditions generally comparable to that which existed under the old gold standard.

Domestic Policy Constraints

Arguments that flexible exchange rates would tend to produce adjustments in line with sustained economic activity and relatively stable prices always assume that exchange rates would fluctuate only moderately because the principal countries participating in the system would successfully pursue policies to achieve stability. But if they tried to do so, the countries would still have to watch their balance

of payments and monetary reserves. They could not disregard limitations imposed by adverse international payments flows any more than they can under a system of fixed exchange rates. Indeed under a system of flexible exchange rates, ignoring adverse flows would risk even more serious effects than under a system of fixed exchange rates.

Even if a country followed appropriate domestic stabilizing policies, flexible exchange rates would make all international trade and investment commitments uncertain. For reasons connected with temporary, cyclical, or even seasonal movements in international payments, exchange rates might at any time break out of their established range. The full faith and credit of governments would no longer stand behind currency values, and confidence that any breakout of an established range would result in a quick return to that range would be lacking. International traders and investors, therefore, would need to incur a speculative risk in all transactions. The costs of such risks would have to enter into prices of exports and imports and into calculations of expected returns on investments.

A system of fixed exchange rates, with narrow fluctuations about parities, can be supported by the same policies for economic stability that advocates of a flexible rate system claim would result in a limited range of exchange rate fluctuation. Since the full faith and credit of governments are pledged in support of currency values, international traders and investors can act in full confidence and with least fear of risk in currency values.

Special Hazards for Key Currencies

International economic activity need not be seriously affected if a currency that is little used or held by foreign traders and investors fluctuates. The country having such a currency and its trading partners will, however, tend to carry on international trade and finance in foreign currencies with fixed currency values, if such currencies are available. The fact that the value of its own currency is unstable will handicap the country in the development of its trade and financial institutions, and lead to a distribution of economic activity between domestic and foreign trade geared to internationally changing currency values. These effects would be much more disturbing if the key currencies also fluctuated.

If a key currency fluctuated freely in relation to gold as well as to other currencies, it could no more function as a standard of economic calculation and as a store of value. Other countries with fluctuating currency values would lose their yardstick for the conduct of foreign trade and finance. Their businessmen, investors, and public administrators would face a double handicap: there would not only be uncertainty about the value of their domestic currency, they would also risk more in their international transactions.

If international currency values should fluctuate, private and public transactors might turn to gold as the standard for economic calculation and for storing value. This development would put great pressure on the limited market supply of gold. The supply not only is small in relation to the demands that might be generated; it also cannot be adjusted to the needs of international commerce and investments as the supply of dollars and sterling can.

The large amounts of dollars and sterling that foreign monetary authorities now hold as reserves and as working balances would become subject to uncertain exchange risk. Even if private transactors would keep their holdings, foreign monetary authorities could hardly do so. The period of transition to a system of fluctuating exchange rate for key currencies would bring danger of a scramble for gold. The system would be put under great pressure from flows of volatile funds, with the price of gold bid up to unforeseeable levels.

Uncontrollable Destabilizing Forces

Advocates of flexible exchange rates underrate the risk involved in permitting rate fluctuations without clearly defined limitations.

What might happen if the United States, with its present large international payments deficit, adopted a flexible exchange rate system? If it did not continue to pursue stabilizing domestic policies, or if its price and cost structure were seriously out of line, the dollar would tend to depreciate continuously instead of fluctuating within a narrow range about a stable value.

Even if the United States tried to stabilize its domestic economy, and its prices and costs were not too rigid, the economic and financial forces generated by flexible rates would make it uncertain whether this effort could be realized. When the dollar exchange rate began to deviate considerably from its customary level, the market might well no longer expect a return to that level but rather would count on progressively wider deviation. Once market behavior became geared to such expectations, it could easily give rise to cumulative movements in financial markets far more difficult to contain than under a system of fixed exchange rates.

Thus, the dollar would tend to depreciate despite efforts to pursue stabilizing policies. Continuous depreciation could lead to speculation against the dollar, which in turn would accelerate the decline in the dollar exchange rate.

In this event, markets for internationally traded commodities would become highly speculative, because with each further decline in the exchange value of the dollar their prices in terms of dollars would rise. The increase in the costs of foreign raw materials would raise costs in domestic industry. In addition, industries producing both for domestic and foreign markets would feel the pressure of increased foreign purchases at bargain dollar prices. A cost-push, demand-pull inflation would start. Speculative activity in the stock market would rise, credit demands would expand, and interest rates would come under sharp pressure.

Domestic inflationary pressures would increase as holders of foreign dollar assets tried to liquidate their holdings before the depreciation of the dollar in terms of foreign currencies progressed. They could do so only by converting their assets, as fast as possible, first into money and then into exportable goods. They would thus add to the upward pressures on interest rates as well as on prices.

Expectations of a continued accelerating decline in the dollar exchange rate would presumably lead to hoarding of foreign currencies by domestic traders and speculators. The hoarding would depress the dollar in terms of foreign currencies even faster than it would reduce the domestic purchasing power of the dollar.

In consequence, exports would be sold at bargain rates. Although the volume of exports in terms of domestic resources would increase sharply,

export proceeds in foreign exchange would increase much less and might even fall. Payments balance would therefore have to come primarily through the drop in the volume and foreign exchange value of imports. This drop in imports, together with the deterioration in the terms of trade, would hurt domestic consumers. Moreover, the drop in imports of producers' goods would handicap the expansion of domestic production.

These disturbances would arouse inflationary processes at home. They might set in motion a self-propelling inflationary spiral, with any increase in inflationary tendencies tending to lead to a further decline in the external value of the dollar. This in turn would further strengthen internal inflationary pressures.

Two special elements of the U.S. balance of international payments would add to the harmful effects of a depreciation of the dollar. First, while the current merchandise balance might improve, depreciation of the dollar would increase the burden on the Federal budget and on the domestic economy generally of those payments abroad for military expenditures and economic aid that must be converted into foreign exchange. Second, continuous depreciation of the dollar might make it ever more attractive for foreigners to borrow in the United States, less attractive to invest in dollar bonds. Thus, the net outflow of long-term capital, at present already a major factor in unbalancing our international payments, would be further stimulated.

Costs of International Commerce

A system of fluctuating dollar exchange rates would also harm other countries of the free world. For a fluctuating rate would in many ways increase the costs and risks of international commerce.

Instead of being able to conclude international transactions on the basis of a stable key currency, everyone engaging in a trade or investment transaction would need to speculate on a possible change in the value of the dollar between the time a commitment was initiated and the time it was concluded. Compared with a fixed parity system with narrow fluctuations (1-1/2 - 3 per cent around par) the transactions risk of this system would be much greater.

For transactions to be consummated quickly the exchange risk could usually be avoided by arranging for forward cover. But the cost would be high because a system of flexible exchange rates would probably bring expectations that fluctuations in currency values would be fairly wide and continuous, and thus lead to high forward premiums or discounts. There are well developed forward markets in only a few currencies. Some international trade and credit transactions would have to be on an uncovered basis if undertaken at all.

For long-term transactions, forward coverage would not be available. Nonspeculative long-term credit transactions would, therefore, be severely handicapped by the risk of fluctuating currency values and so might become virtually impracticable.

Handicaps to Economic Growth

More basically, our objective of advancing prosperity at home and abroad through world trade based on the best international division of labor would be significantly handicapped.

Under a system of freely fluctuating exchange rates, international price relationships would tend to vary more. It would become difficult to rely on international price comparisons in making long-range

investment plans for allocating resources between industries producing for the domestic markets and for exports. Even small changes in exchange rates, say, about 10 per cent, would upset any estimate of relative cost and price advantages in different countries, especially since the changes might be quite unpredictable.

Insofar as extreme fluctuations in industrial output and employment caused by sudden reversals of international competitive positions could be overcome by protectionism, pressures for such protectionism would develop and appear compelling. But if instituted, the trade barriers could only result in slowing economic development and growth internationally.

Possibilities of Intervention

Advocates of a system of flexible exchange rates usually concede the desirability of some official intervention to influence the abruptness and degree of fluctuation in international currency values. But intervention presupposes the availability of monetary reserves in foreign currencies. Unless monetary authorities of different countries would incur the risks associated with a flexible exchange rate system, only gold and currencies borrowed from other reserve banks could be used for such intervention. If reserve or central banks were not willing to enter into cooperative arrangements, only gold sales and purchases would remain. Without enough gold, the system would be without adequate facilities to moderate exchange rate fluctuations in response to volatile and speculative flows of payments.

Concluding Remarks

No responsible government would or could long permit its economy and its international relations to incur the adverse effects that are more likely to occur under flexible than under fixed exchange rates without trying to take preventive or corrective action. Sooner or later it would be involved in efforts to reestablish monetary stability, both internally and externally -- even in an effort to return to a mechanism of fixed rates.

These efforts would eventually mean abandonment of automatic exchange rate adjustments. Both alleged advantages of a system of fluctuating rates -- the advantages of automatic balance of payments adjustments and the advantage of making domestic policies independent of balance of payments and monetary reserve considerations -- would thus have proved illusory.

Board of Governors of the Federal Reserve System,
Division of International Finance,
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