

The Case for Flexible Exchange Rates

In the discussion of proposals for the return by Western European countries and their associated currency areas to currency convertibility, opinion is divided concerning the advisability of combining such a step with the introduction of flexible exchange rates. Although, apart from the report of the Randall Committee which was in favour of flexible rates, authoritative statements on the question are lacking, it is generally believed that there are strong advocates of such a policy in American and British government circles, but that on the Continent official opinion inclines towards the maintenance of fixed rates. Among academic economists, also, there is perhaps more support for flexible rates in Anglo-Saxon countries than on the Continent (1).

The problem of flexible exchange rates has to be examined at two different levels. First, it may be asked whether the reestablishment of convertibility requires the introduction of flexible rates at least for a limited period after which the return to fixed rates may again be envisaged. Secondly, in case the answer to the first question is in the affirmative, it remains to consider whether the return to fixed rates in the longer run is advisable or not. We shall deal with these two questions separately.

(1) In a recent publication on the convertibility problem (« Die Konvertibilität der europäischen Währungen », ed. by A. Hunold, Zürich, 1954) Professor Haberler (Harvard University) and Professor Meade (London School of Economics) advocated flexible rates, as did, in another publication (« Essays in Positive Economics », Chicago, 1953, pp. 157-203) Professor Friedman (Chicago University). The continental writers contributing to the first of these publications took a strong stand against flexible rates; Professor Posthuma (Holland) even went so far as to assert that fixed rates are an integral part of the convertibility of currencies.

I.

In view of the many different meanings which the term convertibility has by now acquired, it seems necessary to start out with a definition. « Full convertibility » of a currency exists if everybody — whether a resident of the country concerned or a non-resident or « foreigner » — who is in possession of that currency can change it freely into any other currency. « Convertibility for foreigners » exists, if « foreigners » who acquire the currency in question can change it into any other currency, whereas residents of the country are not free to possess themselves of any amounts of foreign currency they may wish to buy. « Convertibility for residents » means that the residents of the country are free to acquire as much foreign currency as they wish, whereas « foreigners » — or at least certain groups of « foreigners » — are not free to convert the currency of the country into other currencies, the practical example of this type of convertibility being the Swiss franc. All three types of convertibility are compatible with the existence of quantitative import restrictions. Some authors, however, seem to consider the absence of such import restrictions an integral part of the definition of « convertibility for residents » on the grounds that a resident who cannot import whatever he wishes is *in fact* prevented from making the purchases of foreign currencies he would otherwise make. It seems to us preferable to use the term « liberalisation of imports » for the abolition of quantitative import restrictions, and to reserve the term « convertibility » for the freedom to exchange currencies against one another. Otherwise we should be obliged to say that even in Switzerland, which applies

certain quantitative restrictions to imports of agricultural products, « convertibility for residents » does not exist; and we should have to admit that the convertibility of currencies had disappeared in France and elsewhere as early as 1930, when quantitative trade restrictions were introduced long in advance of the breakdown of the gold standard.

While « full convertibility » must be the final aim, it is generally agreed that it cannot be reached in a single step. Nor does it seem possible to introduce in the near future « convertibility for residents », which presupposes freedom of capital movements, and is a step which many countries — whether rightly or wrongly is here immaterial — are reluctant to take for fear that it may provoke large capital flights. The practical issue therefore lies between the introduction of « convertibility for foreigners », on the one hand, and the complete liberalisation of imports, or what is sometimes called (inappropriately, I think) « convertibility for residents with respect to current transactions », on the other. Much of the recent discussion has turned upon the question which of these two procedures should have priority.

Convertibility of currencies cannot be an aim in itself; it serves a useful purpose only if it affects imports and exports in a direction which is considered desirable. Now, the introduction of « convertibility for foreigners » would undoubtedly direct international trade into channels preferable to those in which it moves at present, because it would get rid of one of the motives for what are usually called « discriminatory trade practices ». Thus if Great Britain introduced this type of convertibility there would no longer be any advantage for her in discriminating against American imports, since an import surplus from any other country could deprive her of dollars just as much as would an import surplus from America. Therefore, if she could not achieve « convertibility for foreigners » without the aid of import restrictions, she would at least handle the latter in a « non-discriminatory » fashion (2), *e. g.* put restrict-

(2) By this is meant formal non-discrimination with respect to imports from different countries; it is clear, however, that import restrictions imposed on certain commodities and not on

ions on « luxuries », no matter where they came from. In other words, her importers would be able to buy, to the extent to which they were allowed to buy at all, in the countries where the goods were cheapest, a result which is undoubtedly desirable in Great Britain's own interest. This type of convertibility would also benefit her in other ways, *e. g.* by making sterling more attractive to hold, and by removing the discount on transferable sterling *vis-à-vis* the dollar.

The introduction of « convertibility for foreigners » requires of course that the country should have reached approximate equilibrium in its overall balance of payments or — in case it trades with soft currency countries with which it has an export surplus the proceeds of which are non-convertible — that it should even have an overall surplus; and it is possible that, on the basis of existing exchange rates and price levels, it may be unable to achieve this equilibrium or this surplus without the aid of import restrictions. We then have to set the advantage of non-discriminatory trade practices against the disadvantage of maintaining or even tightening import restrictions (3). It is understandable that, under these circumstances, a great many economists believe that the liberalisation of imports should come before the introduction of convertibility. This view is apparently shared by the OEEC; it undoubtedly represents the majority opinion on the Continent.

The point I want to make here is that the dual objective of the return to convertibility, even in the restricted sense of « convertibility for foreigners », along with the liberalisation of imports may be impossible of achievement, unless it is accompanied, in many of the countries concerned, by a policy of flexible exchange rates.

To demonstrate this point, let us group the countries of the world into three cate-

others are, as a rule, discriminatory even as between countries, since they restrict imports from the countries from which those particular commodities come, and do not restrict imports from countries in which the commodities on the « free list » originate.

(3) As I have explained in the text, import restrictions would be handled in a different way, so that a comparison between the degrees of restriction before and after the introduction of convertibility, respectively, could never be very precise.

gories: the first consists of countries which, in spite of import restrictions, still have deficits in their balances of payments; the second category consists of countries which, with the aid of import restrictions, are just managing to keep their balances of payments in equilibrium; the third consists of countries with surpluses in their balances of payments. In the last category import restrictions are already reduced to a minimum which is retained not for balance of payments purposes but for protective reasons. Let us assume now that all countries liberalise their imports completely. Assuming exchange rates to remain fixed at their present levels, we can then risk this generalisation as to the outcome: the first group will undergo an increase in its deficit, the second group will run into a deficit, and the third group will have an increase in its surplus (4). Under these conditions the first two groups are not in a position to introduce convertibility, and they must remain soft currency countries, having their deficits financed by the surplus countries via the EPU, unless one of two things happens: either the deficit countries must exercise deflationary pressure on their domestic income and price levels in order to remove their deficits, or they must put into operation a mechanism which tends to restore equilibrium in the balance of payments in some other manner; and the only possibility here is the price mechanism in the form of flexible exchange rates. As there can hardly be any doubt that no country will voluntarily follow the first course, because of the unemployment it is likely to cause, the choice must fall on the policy of flexible exchange rates.

« Convertibility for foreigners » can be introduced, at existing exchange rates, with the aid of import restrictions; and liberalisation of imports can be achieved at existing exchange rates, provided some countries, at least, refrain from introducing this type of convertibility, *i. e.* remain soft currency coun-

(4) There are some countries which cannot be brought under any one of these three categories, countries which have almost completely liberalised their imports in spite of a precarious balance of payments position. These will, of course, benefit from the liberalisation of imports by the others without any offsetting « damage » due to further liberalisation on their own part. Italy is the outstanding example here.

tries; both aims together, however, cannot be achieved unless exchange rates are allowed to move. All that this means is that the existing exchange rate structure is wrong and must be set right if currencies are to be made convertible and imports to be liberalised. Sudden « once-for-all » devaluations of currencies will not be the appropriate device, since the correct exchange rates cannot be calculated in advance but must be found by the market.

II

Advocacy of flexible exchange rates as a temporary measure during the early stages of the return to convertibility does not necessarily prejudice the case in favour of flexible rates in the longer run. It is this longer run aspect of the problem which we still have to discuss. Let us first, however, consider, for purposes of comparison, other methods of dealing with balance of payments difficulties.

Those who favour fixed exchange rates are frequently content to point out the familiar advantages of the latter without making any comment on the crucial problem of what is to be done in case a serious balance of payments deficit arises. The choice of the future foreign exchange policy cannot be made on the assumption of perpetual « fair weather ». Such an optimistic hypothesis assumes the real problem away. If every country could count on uninterrupted equilibrium in its balance of payments, it would not matter much whether the country had, in principle, a fixed or a flexible exchange rate system, since there would even under the latter be no reason for the rates to fluctuate widely, so that both systems would practically amount to the same thing. It is the case of a « fundamental disequilibrium » in the balance of payments which we must have in mind when making our choice.

Given that exchange rates are to be kept fixed, the authorities can, when faced with such a disequilibrium, take several alternative lines of action:

(1) They can exercise deflationary pressure. The use of this method amounts in effect to returning to the gold standard. If

prices and, in particular, wages were flexible downwards, deflation would in the last analysis work in the same way as a fall in the foreign exchange rate. For in both cases the equilibrium in the balance of payments would be restored via a fall in the domestic price level of the country concerned relative to the world price level. Under modern conditions, where downward flexibility of prices and wages does not exist, a deflationary policy produces unemployment and a decline in national income, and thereby a reduction in the demand for imports; and the adjustment in the balance of payments takes place predominantly through this decline in income rather than through a relative fall in prices. The difficulties of restoring equilibrium through deflation are likely to be heightened by the behaviour of the « surplus » countries. Unless they are engaged in expansionist monetary policies for other reasons, *e.g.* as a cure for unemployment, they will be reluctant to follow the policy of increasing the money supply which the rules of the gold standard would recommend; and thus the entire burden of the adjustment will fall on the shoulders of the deficit country. These considerations leave little room for doubting that the orthodox gold standard policy of dealing with a deficit in the balance of payments is at the present time outside the realm of practical possibilities. No country is likely to subject itself to the discipline which the gold standard imposes.

(2) An alternative method of maintaining exchange rates fixed in face of serious balance of payments difficulties is the introduction of foreign exchange control or, at least, of quantitative restrictions on imports in the form of quotas or licences. The resort to this method would mean a complete reversal of the direction in which international economic policy has been guided throughout most of the postwar period; but it is nonetheless true that those who advocate fixed exchange rates while objecting to the gold standard method of dealing with deficits have no choice but to recommend foreign exchange control, or quantitative import restrictions, as the only method of overcoming a balance of

payments crisis. And there is undoubtedly a grave danger that just this method will be chosen in the future. The experiences and discussions of recent years are ample enough to make it unnecessary for us to describe the drawbacks of this method in detail. The arbitrariness of the administrative measures which have to be taken; the direction of international trade into channels other than those determined by comparative advantage; the time-lag with which the measures are taken, as has been most clearly illustrated by the British case; the difficulty of removing the controls again once vested interests have grown up under their protection; the possible retaliation by other countries; the domestic repercussions which may run counter to the object the measures are intended to achieve, as for instance when consumers who are prevented from buying certain import goods use the corresponding purchasing power to buy goods that were previously exported; — all these and other reasons make the choice of this method an extremely undesirable one.

(3) Many of those who advocate fixed exchange rates as the ideal system, admitting that neither deflation nor import controls are to their liking, are willing to compromise in favour of sudden devaluations which substitute a new « fixed » rate for the one that can no longer be maintained. This is the method incorporated in the statutes of the International Monetary Fund. Such devaluations were to proceed — and it was here that the authors of the Fund saw a particular advantage — in an « orderly » fashion, by which was meant that they should be agreed upon by all members of the Fund so that competitive devaluations would be excluded. The objections to this method of dealing with balance of payments difficulties are several:

(a) At least one of the main advantages of fixed exchange rates is lost once those engaged in foreign exchange dealings are obliged to allow for the possibility of sudden devaluations. The advantage I have in mind is the encouragement which fixed exchange rates give to international capital movements at long term. When investors are no longer

able to rely upon the monetary authorities' following a policy of fixed rates through thick and thin, capital will not move between countries with the same facility as under the gold standard.

(b) Whenever a strain on the foreign exchange rate develops, the possibility of a devaluation will induce speculators to conduct bear operations against the currency concerned. This type of speculation is practically riskless, inasmuch as the worst that can befall those who undertake it is the disappointment of their expectations because the devaluation does not come off; even if they make no profits they still do not make losses, unless we count the costs of operation, which are small. The important point here is that no counterspeculation will set in; the speculation is exclusively of the « destabilising » kind. Acting entirely in one direction it may easily force upon the authorities a devaluation which might otherwise have been avoided.

(c) A minute's reflection, as well as past experience, shows that an « orderly » devaluation which is preceded by a discussion amongst the members of the Fund, is an impossibility, the reason being, of course, that such discussion and the publicity which almost inevitably attends it immediately calls forth the type of speculation we have just mentioned. A country which devalues necessarily has to proceed single-handed and in great secrecy. But, since the correct exchange rate cannot be known in advance, the tendency for a country which proceeds unhindered by the obligation to reach agreement with others will usually be to devalue its currency beyond the desirable point in order to be on the safe side — a « beggar-my-neighbour » policy which will be rightly resented by other countries and may easily result in forcing them to resort to devaluation also.

(d) The decision to devalue the currency is, as a rule, postponed until the strain, aggravated by the effects of speculation, becomes so great that the devaluation is practically forced upon the country. This again means that the degree of devaluation is likely to be greater than would otherwise be necessary, simply because the forces which are

needed to restore equilibrium are called into play too late.

For all these reasons the policy of sudden devaluations is not one to be recommended. We shall see that a policy of fluctuating rates is on all these counts superior to the policy envisaged in the statutes of the Monetary Fund.

III

It behoves us not to follow what is rather a widespread habit among economists: the habit of criticising the weak points of a given policy proposal and immediately dismissing it without stopping to consider whether a better alternative can be suggested. What we have said so far, does not yet justify us in inferring that either the policy of maintaining fixed exchange rates, whether at the cost of deflationary pressure or of import controls, or the policy of sudden devaluations is to be rejected. We have still to show that a policy of fluctuating rates is superior to both of these policies. Admittedly, a policy of flexible exchange rates also has its weak points; there is no « perfect » method of getting out of balance of payments difficulties. And even if the advantages and disadvantages of each of the various policies under discussion can be clearly set forth and agreed upon, weighing them against each other before arriving at a final recommendation will invariably leave room for personal judgment, so that we shall always have to expect disagreement among economists and experts: some for instance ultimately preferring import controls and the others fluctuating exchange rates, their choice undoubtedly being influenced by their prejudices for or against government interference in the economic process. Let me then try to set out the strong and weak points of the system of flexible exchange rates and to give my personal view on the question: In favour of which policy are the scales most heavily weighed?

The main advantage that can be claimed for a policy of flexible exchange rates is that it allows a country both to avoid quantitative import controls and to follow (at least within certain limits to which we shall refer below)

an « independent » monetary policy, *i. e.* a policy that is unaffected by deficits or surpluses in its balance of payments. Under flexible exchange rates a deficit does not force a country into a contraction of its money supply with unemployment as a result, nor does a surplus force it into an expansion of its money supply with rising prices as the consequence. In most of the discussions only the first of these two situations is stressed, but the second also merits attention. Its importance is evident at the present time when the monetary authorities of some of the countries with surplus positions in the EPU are beginning to show signs of nervousness on account of the monetary expansion which the surpluses entail — a clear indication, incidentally, that they would not be willing to follow the rules of the gold standard, which would require that, in face of a balance of payments surplus, they should increase the money supply.

This argument for flexible exchange rates is, according to the opponents of such a policy, offset or weakened by a number of considerations:

(1) It is contended that the whole theory according to which flexible rates will bring about an adjustment in the balance of payments is mistaken. This is an argument which, if correct, would of course apply equally well to the method of sudden devaluations. Those who take this position point out that a decline in a country's foreign exchange rate will have the desired effect on its balance of payments only if certain elasticity conditions are fulfilled, and they claim that these conditions are not in fact fulfilled. On the purely theoretical level a complicated formula has been developed on the basis of four elasticities: the elasticities of supply for exported and imported goods respectively, and the elasticities of demand for these two categories of goods. Of these four elasticities, the two elasticities of demand are the more important. And if we concentrate only on these — *i. e.* if we assume that the two elasticities of supply are infinite — the formula reduces to the simple one according to which, when a country starts from a position of equilibrium in its balance of trade, a fall in its foreign exchange rate

will lead to an excess of exports over imports provided the sum of the two elasticities of demand is greater than unity. Many statistical investigations have been made to determine the actual values of these two elasticities for various countries; and the results have induced what has been called an « elasticity-pessimism » leading to a widespread conviction that, under modern conditions, quantitative import restrictions are the only way of dealing effectively with a balance of payments crisis.

Under closer examination the methods and the results of these investigations appear to be of doubtful validity on a number of grounds. It suffices here to call attention to two of these. First (as Orcutt (5) has shown) the statistical methods employed are such as to give a bias to the results in the direction of low elasticities. Secondly, it is almost generally agreed that not much reliance can be placed on the results of investigations of the elasticities of global demand for imports or exports — concepts which, incidentally, have a definable meaning only if it can be assumed that the composition of total exports or total imports remains unchanged so that all imports or exports can be treated as if they were a single commodity. As a consequence of the criticism levelled against the attempts at establishing global elasticities, the statistical investigations have more and more been directed towards the evaluation of elasticities for individual commodities. This is certainly a more satisfactory procedure; but, in view of the amount of work that is involved, it has so far been necessary to confine the investigations to the more important commodities among, for example, imports into the United States; and the inference from the elasticities for these individual commodities to the elasticity for the total of imports is open to obvious criticism.

On these two grounds alone it seems very doubtful whether the statistical results obtained justify the conclusion that a fall in the exchange rate will fail to have the desired effect on the balance of payments. I am

(5) GUY H. ORCUTT, *Measurement of Price Elasticities in International Trade*, « Review of Economics and Statistics », 1950, pp. 117-32.

inclined to agree with Professor Friedman's statement that « as a purely theoretical matter, there will always be some set or sets of rates that will clear the market, and, in the neighbourhood of at least one of these sets of rates a rise in the rate will mean a decline in excess demand... and... a fall, a rise in excess demand » (6). It seems to me most probable that those writers were right who, like Marshall, pointed out that the elasticity of demand for the exports of an individual country is likely to be high, since this country usually competes with other countries supplying the same or similar commodities. « To-day », writes Professor Haberler « one can say with confidence that the elasticity-optimism of the classical writers, based on general theoretical and empirical considerations and on a long experience have stood the test much better than the elasticity-pessimism seemingly supported by the work of econometricians » (7).

If elasticity-pessimism were justified, the case for flexible exchange rates would fail for this reason alone. But even if, as I believe, it is not justified, there still remain a number of objections against flexible exchange rates. Reserving the two most serious objections to the last, we shall first dispose of some minor ones.

(2) Men in responsible positions in Central Banks sometimes make the point that the obligation to maintain fixed exchange rates provides them with a powerful defensive weapon against various kinds of pressure to expand the money supply which are continually being brought to bear upon them, and which they would be unable so firmly to resist without this weapon. There is undoubtedly something to this argument. But

(6) *Op. cit.*, p. 160.

(7) HABERLER, *Die Ausgleichsgesetze der amerikanischen Zahlungsbilanz*, « Schweizerische Zeitschrift für Volkswirtschaft und Statistik », p. 509.

A thorough discussion of this point would require a separate article. I do not believe that the question can be settled by reference to the four elasticities mentioned in the text. The application of the method of partial equilibrium analysis to such a large sector of the economy as foreign trade is not justified; only general equilibrium analysis which takes account of the repercussions of a change in the exchange rate on the level of income, on income distribution and on relative prices would be capable of giving theoretically correct results.

its force is strictly limited to the case where the pressures are inflationary in nature. In the case of a serious balance of payments crisis, when the maintenance of fixed exchange rates requires the opposite, *i. e.* deflationary action, no Central Bank will today be enabled to carry through a policy of actually contracting the money supply by pleading the necessity of maintaining the exchange rate. So far as the pressure towards inflation is concerned, the argument loses its force if the country is experiencing an economic contraction. In such a situation monetary expansion is usually desirable, and it is precisely one of the advantages of flexible rates that they allow such an expansion which a regime of fixed rates might, for balance of payments reasons, render impossible. In the case of inflationary pressure in a « full employment » economy, or in an economy which is suffering from a type of unemployment that cannot be remedied by an expansion in the money supply, it may be conceded that the argument has some validity. On the whole, however, it seems that we should be sacrificing too much if we were to forgo the advantages of flexible exchange rates merely in order to give the Central Bank a firmer stand against pressures brought upon it, for mistaken reasons, to follow an inflationary policy.

(3) It is said that fluctuating exchange rates hamper international trade by adding to the risks of traders. This argument loses most of its force when we consider that a well-functioning forward exchange market, which would of course have to be created or recreated in case a policy of flexible rates were to be pursued, would allow traders to hedge against this risk by shifting it on to the shoulders of speculators deliberately specialising in this type of business. Moreover, it should be remembered that this kind of risk is present in any case, and that it is only the form which it takes that varies under different balance of payments policies. Thus, if, in order to remove a disequilibrium in the balance of payments, a policy of deflation is used, the trader's risk lies in the possible decline of domestic demand and of domestic prices; and if import controls are applied it

consists in the possibility that such controls may cut off, partially or wholly, their access to the sources of supply of certain commodities. Those who stress the risk factor are often unconsciously comparing the policy of fixed exchange rates under the assumption of equilibrium in the balance of payments with the policy of flexible rates under the opposite assumption of disequilibrium in the balance of payments, a comparison which is irrelevant.

(4) Fluctuating rates will, it is contended, reduce the volume of international long-term lending. This would be a valid criticism if, as was the case in the nineteenth century, investors could rely on the countries to which they lent their funds neither to alter the exchange rate nor to introduce foreign exchange control. It is questionable whether to-day, after twenty-five years of experimentation with monetary standards, international investors can be persuaded that the capital-importing countries will never resort to such measures in order to « protect the balance of payments ». It seems extremely unlikely that, even with a formal adherence to the principle of fixed exchange rates, private capital will, in the foreseeable future, ever again flow with the same ease across the borders as it did in the past century.

We come now to the two most important arguments against flexible exchange rates: the first is the danger of the so-called wage-price-spiral, the second the danger of what is usually called « destabilising » speculation in the foreign exchange market.

(5) A fall in the foreign exchange rate, by making imported commodities more expensive, raises the cost of living and provokes demands from organised labour for higher wages. If these demands are granted, so the argument runs, the beneficial effects of the depreciation of the currency on the balance of payments will be lost.

This is a serious argument against flexible rates, which applies equally well, of course, to sudden devaluations. If the wage demands are met, the monetary authorities will be called upon to finance them by expanding the money supply. If they resisted, un-

employment would most likely result, and in that case a flexible exchange rate policy would turn out to have much the same consequences as a policy of maintaining fixed rates through deflationary pressure. It is true that the consequences would still not be quite the same: for the unemployment created in this way would be less than that created by a deflationary policy, since under the latter the real wage rates of the workers remaining in employment would actually rise instead of merely staying at their old level. Nevertheless, one of the main advantages usually claimed for a flexible exchange rate policy would be lost. If, on the other hand, the monetary authorities do provide the necessary addition to the money supply, it is an action which comes perilously near to allowing the trade unions to make the monetary policy of the country. This is merely one example of the general dilemma which arises whenever the trade unions press for wage increases that exceed the growth in the productivity of labour. Indeed wage demands which follow on a fall in the foreign exchange rate are of the same kind, inasmuch as the deterioration in the country's terms of trade entailed by the fall in its exchange rate means, in effect, a lower productivity of labour which ought to be reflected in lower real wages. The attempt to maintain real wages, if successful, amounts to shifting the decline in real income on to the shoulders of other groups in the society including those who are pushed out of employment.

Even if demands for increased money wages following on a fall in the exchange rate cannot be entirely resisted, we should not exaggerate the extent to which the argument that a fall in the exchange rate will help to adjust the balance of payments has to be qualified. In no case will the rise in the cost of living index fully reflect the fall in the exchange rate: for a large part — as a rule the larger part — of the commodities that enter into the cost of living index are domestic commodities and services. Unfortunately the evidence concerning this point which we can gather from the effects of the devaluations of European currencies which took place in September 1949 is not conclu-

sive. First of all, only the period from September 1949 to June 1950 is significant, since after the latter date the effects of the Korean crisis overshadow the effects of the devaluation on the cost of living indices. Secondly, world prices had fallen during 1949; and although this price fall had almost come to an end by September 1949, it must, because of the usual time-lag, have effected the cost of living indices during the period under consideration. The fact, then, that the cost of living indices in that period actually fell in Italy and Germany, and remained almost stable in Great Britain and Sweden, does not prove that the effect of an adjustment in the exchange rate on the cost of living index is unimportant. Moreover, in some countries the index did rise: the sharpest rise — if we exclude France where inflation had not yet come to an end — took place in the Netherlands, where the index had, by June 1950, risen to 11 per cent above the September 1949 level — a rise which was, however, probably not entirely due to the devaluation of the guilder. In any case, even if we allow for the earlier decline in world prices which, as measured by the wholesale price index of the United States, amounted to 10 per cent between August 1948 (when the index had reached its peak) and September 1949, in none of the countries does the cost of living index come anywhere near reflecting the full depreciation of the currency (which would have required, for a 30 per cent depreciation, a rise in the cost of living index, relative to the world price level, of 43 per cent). The effect of a currency depreciation on the balance of payments, though it will certainly always be modified by the working of the wage-price-spiral, will never be nullified by it. Moreover, the double time-lag — first between the depreciation and whatever rise in the cost of living it causes, and secondly between the rise in the cost of living and the rise in the wage level — will always provide an interval of considerable length in which the fall in the exchange rate exerts a maximum effect on the balance of payments.

It should be observed also that the alternative policy to that of flexible exchange rates, namely the imposition of import restrictions,

is not entirely free from the same objections. These reduce the supplies of foreign commodities coming on to the home market, and therefore lead to a rise in the domestic price level just as much as does a depreciation of the currency. But — and here we meet the best argument that can be made in their favour — it is possible for the authorities to impose them wholly or partly on commodities which do not enter into the cost of living index. The exclusive selection of such « luxury goods » presupposes of course that they have previously bulked sufficiently large in total imports for restrictions on their importation to cut down the total to the extent that is required. Even then the primary effect of such restrictions on the balance of payments may be partly offset by certain secondary effects. Those who are prevented from buying the previously imported goods will purchase other goods which may be either export commodities, or import commodities which are still on the free list, or domestic commodities which do enter into the cost of living index; thus the import restrictions may improve the balance of payments to a lesser extent than appears likely at first sight. When account is taken of the other disadvantages of trade restrictions mentioned earlier it seems to me that flexible exchange rates are still preferable to import controls.

(6) A final argument against flexible exchange rates arises out of the fear that speculation in the foreign exchange market may be of the « destabilising » kind.

In so far as speculators in the foreign exchange market anticipate future movements in the rate and, by operating accordingly, help to smooth out those movements, they perform an important task. If the speculators, taken in their entirety, guess the future course of the rate approximately correctly, speculation is undoubtedly beneficial, because it brings into action, early in the game, the forces which lead to the adjustment of the balance of payments. In contrast to what happens under the method of sudden devaluation, the incentive to export more and to import less is here created as soon as balance of payments difficulties begin to ap-

pear on the horizon. If, then, we could rely on the speculators to gauge the future correctly, flexible exchange rates would, just because of the speculation, constitute a particularly quick and smooth mechanism for adjusting the balance of payments.

The critics argue, however, that speculation will usually drive the exchange rate below the equilibrium level. Although admittedly such a danger exists, it would not seem to be a very serious one. First of all, the over-buying of foreign exchange would be only temporary since it would sooner or later cause exports to rise and imports to fall so markedly as to create an excess supply of foreign exchange which would bring about the recovery of the rate. Secondly, the assumption of «overspeculation» implies that the speculators taken as a whole must, in the end, have made losses. Undoubtedly this is a possibility, but it seems more reasonable to assume that, as a general rule, the opinions of the speculators as to the future of the rate will, from a certain point on, be divided, so that some begin to undertake «counter-speculation», selling their foreign exchange in order to realise their profits (counter-speculation which, as we know, will not set in when the speculators expect a sudden devaluation). It does not therefore seem very likely that speculation in the foreign exchange market will greatly accentuate the fluctuations in the rate. The experience of the thirties, on which the fear of overspeculation is largely based, is by no means conclusive. At that time the purchases of foreign exchange came partly from those who were engaging in capital flight, and the fact that in some cases the rates were pushed below the level that was warranted cannot, therefore, be imputed solely to the operations of the professional speculators. In the case of France, the speculation against the franc was, as long as France clung to a fixed rate, undoubtedly of the «destabilising» kind; but it was just the type of riskless speculation which we have discussed in connection with the policy of sudden devaluations, and cannot be adduced as an example of overspeculation relevant to the case of flexible exchange rates.

IV

One more point remains to be discussed. Thus far we have made no mention of stabilisation funds which perhaps most of those who advocate flexible exchange rates consider an integral part of their policy proposal.

It is, however, far from self-evident that a stabilisation fund is a desirable adjunct to the system of flexible exchange rates. It will exercise a positive function only if the managers of the fund are abler, or better informed than the private speculators, so that they are in a position to foresee the future course of exchange rates more accurately. It is not easy to see why this should be the case. There is, on the contrary, a certain danger that the managers of the fund may, in pursuing their task of smoothing out «day-to-day» fluctuations, attempt for some time to hold the rate up in face of a situation which requires a fundamental adjustment of the balance of payments through a fall in the rate.

But this is not the only aspect of the problem. If several countries follow a flexible exchange rate policy and each of them has a separate stabilisation fund whose activities are not coordinated with those of the others, the various funds may, quite possibly, act at cross purposes, *i. e.* fight each other. Were this to be the case, it would certainly be better not to set up stabilisation funds at all. And if, as is likely, the countries insist on having stabilisation funds, it is of paramount importance that their activities should somehow be coordinated. This means common deliberations among the managers of the different funds, and amounts to something very close to setting up a European Stabilisation Fund which might take the place of the EPU.

Whereas rather conclusive arguments can be brought against separate national stabilisation funds, there is something to be said in favour of such a European Fund, in particular if the body that runs it is given power to press for coordination of the monetary policies of the member countries.

We do not of course, in advocating flexibility of exchange rates, suggest that the

United States should give up the fixed price of gold; and the countries following a flexible exchange rate policy would thus have domestic gold prices which moved in accordance with the dollar rate. The speculators and the European Fund could carry on their operations equally well in dollars or in gold. Gold would remain an international means of payment, though gold flows would not, of course, exercise the «equilibrating» effects on the balance of payments which they supposedly had under the orthodox gold standard. Purchases or sales of gold by the Central Banks would be equivalent to an attempt on their part to influence the exchange rate, *i. e.* it would mean that they acted in the same manner as the stabilisation funds; and such transactions by the Central Banks should, at least when they are large, only be carried out after consultation with the European Fund.

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The analysis of the arguments for and against a policy of flexible exchange rates, as well as for and against other methods of dealing with balance of payments difficulties, leads me to conclude that the system of flexible rates is the best method available to us. I am, of course, far from predicting that this policy will actually be pursued in the future. In spite of the success of the British policy of flexible rates in the 'thirties, and in spite of the success of the Canadian policy of the last few years, most men in responsible positions on the Continent feel an almost instinctive distrust of such a policy. For them it means a departure into an unknown land in which they have no past experience to guide them — an attitude which is understandable and by no means surprising. Nonetheless, considering the alternatives that are available, this departure would, in my view, be worth risking. In order to facilitate it, it may be well to experiment first with a system which allows exchange rates to fluctuate only

between well-defined limits, limits which would, however, need to be considerably wider than the existing ones. Such a system would work as long as the speculators were convinced that the limits could be kept. Under this assumption speculation would work in the right direction, tending to drive up the rate when it has fallen to the lower limit and to drive it down when it has risen to the upper limit. The danger of this system is of course that, as soon as the speculators feel that the lower limit cannot be held, a «one way» speculation of the type we have discussed in connection with sudden devaluations will set in, and may force the authorities to sacrifice the lower limit. The wider the limits are chosen the less likely is it that this situation will arise. If, therefore, such limits are required in order to ease the way towards a policy of flexible rates, they should not be set too narrowly. Provided this type of compromise between fixed and flexible rates helps to overcome the resistance to the latter, it is worth trying — although an «unrestricted» policy of flexible rates, avoiding, as it does, the danger of «destabilising» speculation, is in principle preferable.

One final word may be added. Flexible exchange rates do not necessarily mean unstable exchange rates. As long as the balance of payments was approximately in equilibrium, exchange rates would not fluctuate widely, and over long stretches of time the difference between what are in principle flexible rates and what are in principle fixed rates would not be greatly felt. The fear, therefore, that flexible rates would mean a radical change from what we have been used to is unwarranted, except of course in the case of a serious balance of payments crisis. And in such a situation the policy of flexible rates is, as I have tried to show, that one amongst the possible policies which minimises the adverse effects on the economy of the country concerned.

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