

Under modern systems of managed convertible currencies, so runs the argument of advocates of a fluctuating rate system, this mechanism of adjustment does not have its former effectiveness because policies of governments, business, and labor in deficit countries are geared to resist a downward adjustment in prices and wages; while in surplus countries, governmental policies may be directed at resisting an upward adjustment of prices and wages. In the modern setting, in other words, public policies in major industrial countries are especially directed at domestic price and cost stability as a means of facilitating high-level employment and maximum economic growth. Hence, the tendency is to temper or offset the domestic impact of balance-of-payments developments that might otherwise frustrate achievement of domestic policy objectives.

This line of reasoning leads to the view that present-day governmental policies, together with prevailing attitudes of business and labor, no longer facilitate, but in fact hamper the interplay of monetary, price, and interest rate forces working to bring about balance in international payments. Imbalance in payments, if taken into account in domestic programs, tends to be regarded mainly as a condition limiting governmental discretion—a condition to be met for the purpose of maintaining a stable value for a currency internationally. In this context, it is asserted that a system of fluctuating exchange rates offers an alternative mechanism of adjustment, with greater promptness in converting imbalance in payments into balance and more freedom to pursue domestic goals of economic policy.

Under a system in which exchange rates would be permitted to respond freely to changes in market supply and demand forces, without Government limitation or intervention, the mechanism of adjustment would involve both major types of international transactions—the movement of goods and services (mainly merchandise) and the movement of capital (especially short term). For simplicity, the adjustment appropriate to a deficit country will be used as an illustration.

A deficit country would find the demand for its currency low relative to the supply of it in exchange markets, so that its currency would become less valuable in relation to other currencies. The changes in commodity prices that would result would be influenced by the price and income 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.

Insofar as domestic goods were substitutable for imports, the higher prices for imports would encourage the expansion of domestic production of competitive goods, and thus would 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, among other factors, on the presence or absence of unutilized capacity in the import-competing industries and on the length and complexity of the production process.

If some foreign exporters were able and willing to reduce their prices in terms of foreign currencies (i.e., to maintain their prices in terms of the depreciating currency) in order to keep their import markets, adjustments in the deficit country would be less. But there would still be some reduction in foreign exchange expenditures even if the quantity of imports were maintained as a result of price responses of foreign exporters.

*Effects on exports.*—Effects on the exports of the deficit country would depend on the organization and structure of its industrial and agricultural production and the competitive position of its export products in world markets. For one-product material or food producing countries facing relatively inelastic demand schedules for the particular commodity, exchange depreciation might leave the export volume unchanged but reduce the foreign exchange proceeds of exports. For industrialized countries with diversified exports competitive with similar products of other industrialized countries, however, the result would probably be some increase in the volume of exports and in foreign exchange receipts. The increase would be the larger, the greater the previous underutilization of existing capacity.