

case would tend to make the depressed country's currency appreciate, and the effects of appreciation could work to aggravate the domestic recession.

Nevertheless, if a government were to embark on fiscal and monetary policies of an expansionary character, a capital outflow might be induced strong enough to overcome the effects of an improved balance of payments on current account. In this situation, the currency would depreciate and this would reinforce such upward cost and demand pressures on prices as were being generated by the anti-recession domestic policies.

In case of a worldwide recession from which all countries suffer, exports and imports, as well as foreign lending and borrowing activity, of all countries would be expected to drop. Any resulting effects upon exchange rate relationships in these adverse circumstances would largely reflect the uneven incidence of the recession.

Effects on capital movements.—Even if it be assumed that with fluctuating exchange rates compensating adjustments would tend to occur in the trade account, there would remain the problem of volatile 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.

Volatile capital movements are greatly influenced by psychological and expectational factors. The only experience the world has had with fluctuating rates has been under an international currency system where floating rates were the exception rather than the rule. There has always been at least one currency, the dollar, convertible into gold at a fixed rate, except for a brief period in 1933-34. For this reason, it is impossible to know what might have happened in a world of flexible rates.

If the principal countries promoted a reasonable degree of stability in economic activity and domestic prices,¹ a theoretical expectation would be that wide fluctuations in exchange rates would not occur. So long as a flexible currency was freely convertible into goods and property claims for export, at relatively stable prices, it could not depreciate far before it would begin to appear a bargain both to commodity 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 traders and 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 currency is so overvalued or undervalued that existing rates cannot be or may 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. There is no reason to expect that the market opinion derived from this analysis would be dominantly bullish or bearish, though in particular circumstances either market attitude might well predominate.

Any speculative movement into a currency, however, 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. Obviously, the possibility of loss would be much greater than under a system of fixed exchange rates with its narrow spreads. The existence of this speculative risk would tend to dampen, and eventually reverse, any speculative movement of funds between international money and capital markets not warranted by relative price changes.

Effects on domestic financial stability.—Even if it be assumed that fluctuating rates would work to balance international accounts, the problem remains whether they would lead to violent fluctuations in domestic prices. A frequent argument in support of fixed exchange rates is that such a system makes it easier to receive support for stabilizing monetary and fiscal policies. Under such a system, any deviation from sound policies will lead to depletion of the country's reserves of gold and foreign exchange, and declines in such reserves will show the need of, and bring public support for, appropriate fiscal and monetary policies.

¹ In the absence of such policies, any system of exchange rates—fixed or flexible—would tend to break down.