Proponents of variable exchange rates argue that governments would actually be better able to follow stabilizing fiscal and monetary policies under a system of floating rates than under a system of fixed rates.

They contend that the rate of exchange of a currency is much more widely known and understood than the amount of, and changes in, a country's international reserves. Thus, exchange rate depreciation is more apt to show the need for, and bring timely public support for, appropriate fiscal and monetary action than a decline in a country's international monetary reserves.

A MODIFIED SYSTEM OF FLUCTUATING RATES

Up to this point a system of freely fluctuating exchange rates applicable to major industrial countries has been contemplated. 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. Such a system is hardly realistic, however. Proponents of fluctuating rates usually acknowledge that some official intervention would be desirable 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 variable exchange rates would, however, be faced with two problems.

The first relates to the assets that would be used as monetary reserves. The key trading countries might seek to rely mainly on gold as a monetary reserve asset, for the reason that gold would be more likely than any currency to retain its value in relation to the domestic currency and to the currencies of other industrial countries. That is to say, their willingness to hold reserves in other important currencies would depend heavily on whether these currencies had, in fact, proved stable enough to inspire confidence that this stability would continue. But if central banks would not hold reserves in foreign currencies as a regular matter, they might still from time to time, as a matter of central bank cooperation, engage in temporary reciprocal currency transactions to enable the participating central banks to intervene in the foreign exchange market in behalf of their currencies.

The second problem has to do with the internationally accepted rules that would govern official intervention in exchange markets to affect the international value of a currency, especially as to intervention that would appear to have the purpose of competitive depreciation. To be sure, such rules do not exist at present, but they might be developed over a period of time through a process of international discussion and cooperation.

If these problems could be solved—and they are indeed problems of inherent complexity—then advocates of a modified variable rate system would argue that such a system might offer advantages besides those already discussed.

Speed and amount of adjustment

Under a modified system of fluctuating exchange rates, the monetary authorities of an industrial country would not be so tempted to delay a rate adjustment when conditions seemed to make such an adjustment unavoidable as they are under a fixed exchange rate system. Such delays may slow the adaptation of a country's economy to its needs for external balance, with a resulting erosion of its monetary reserve position.

Under a fixed exchange rate system, the exchange rate is both a focus of diverse business and labor interests and a symbol of financial prestige. Consequently, a devaluation or revaluation, if taken, risks criticism as harmful to these interests and also as evidence of some failure of the Government's economic policy and as a breach of faith with the public. Devaluing or revaluing a currency in terms of gold and other currencies thus becomes an action to be resisted as long as possible—an action of last resort. At times, countries have imposed, or reimposed, or tightened exchange and trade controls rather than adjusting their currency value internationally.

When devaluations or revaluations become unavoidable for major countries, moreover, they tend to be a disruptive factor in international trade and finance, and since they are arbitrary actions to resolve a complicated problem, they risk being either too large or too small. Under a fluctuating exchange rate system, if a currency were overvalued or undervalued, any necessary depreciation or appreciation of the rate would have a chance both of achieving an equilibrating level and of coming soon enough to avoid an extended period of disequilibrium.