

in transactions with countries having currencies of unstable foreign exchange value.

A general system of variable exchange rates presupposes that it could be applied to the reserve currencies as well as the currencies of other industrial countries without endangering the continued expansion of world trade and finance. But even if floating exchange rates were harmless or advantageous if applied to currencies little used or held by foreigners, a general system of such rates would be undesirable if its application to reserve currencies rendered the international payments mechanism inefficient and unstable.

Worldwide economic activity need not be seriously affected if a currency little used or held by foreign traders and investors is permitted to fluctuate. The country having such currency and its trading partners will probably carry on most of the necessary international trade and finance in a reserve currency, if such a currency is available.

But if a reserve currency were permitted to fluctuate freely against all other major currencies and also in relation to gold, the reserve currency could no longer find general acceptability. It would no longer be widely used or held by foreigners, and, because of the interrelations of domestic and international economic activities, its usefulness as standard of value and store of value for domestic transactions would also be impaired.

Burden on international trade and investment

Primarily, the effects of a change from an exchange rate system anchored to fixed parities for industrial countries to a general system of rates varying with changes in the supply of and demand for their currencies would be felt in international trade and investment.

Instead of being able to conclude international transactions on the basis of a stable reserve currency, everyone engaging in a trade or investment transaction would need to speculate on a possible change in the international value of his own currency and that of some other country between the time of making a commitment and the time of concluding it. Compared with a fixed parity system with narrow fluctuations (1½ to 2 percent around par), the transactions risk of such a flexible rate system would be very much greater.

For transactions scheduled to be consummated quickly, exchange risks in many cases could be avoided by arranging for forward cover; but the forward cover would not be costless, for the exchange risks would not be carried by other parties except at a price.² Numerous international trade and credit transactions, moreover, would have to be on an uncovered basis, if undertaken at all, since there are well-developed and efficient forward markets in only a few currencies. Finally, forward cover would not be available for long-term loan transactions, and such transactions would be severely handicapped by the uncertain risk of fluctuating currency values.

Thus, a generalized system of freely variable exchange rates would directly increase the risks and costs of international commerce and finance. The effects of these greater risks and higher costs would be a contraction and reduction of international trade and, in consequence, a reduction of economic activity in the countries currently benefiting from a larger volume of commerce among them.

If the foreign exchange values of currencies of all industrial countries fluctuated, private and public transactors, especially in the international sphere, might turn to gold as the standard for economic calculation and for storing value. The huge amounts of dollars and sterling that foreign monetary authorities now hold as reserves and as working balances as well as the dollars and sterling held by banks and other private interests would become subject to unpredictable exchange risk. Even if private transactors were willing to retain their dollar and sterling holdings, it is unlikely that foreign monetary authorities would be willing to do so. The result would be great demand and price 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 as readily adjusted over time to the needs of international commerce and investment as can the supply of dollars and sterling.

² Forward exchange rates would no longer correlate closely with short-term interest rate differentials between markets, but would more heavily reflect expectations as to future fluctuations in spot rates. These expectations, as between major markets, might contrast sharply at a given time.