Handicaps to economic growth

More basically, the generally accepted free world objective of advancing prosperity at home and abroad through international trade based on the best geographic division of labor and other resources would indeed be seriously handicapped.

Under a system of freely fluctuating exchange rates, international price relationships would tend to vary more widely and unpredictably. It would become impractical to rely on international price comparisons in making long-range investment plans for allocating resources between production for the domestic markets and for exports. Even relatively small changes in exchange rates would upset any estimate of relative cost and price advantages in different countries.

Insofar as extreme fluctuations in industrial output and employment caused by sudden reversals of international competitive positions could be overcome by protectionism, pressures for such protectionism would develop and appear compelling. Any resumed multiplication of trade barriers could only result in slowing economic development and growth internationally.

Price function of an exchange rate

The function of an exchange rate is more similar to that of a country's overall price level than it is to the price of an individual commodity or service. Stability of the level or average of prices, in contrast to stability of individual prices, has been generally recognized as a prerequisite of sustained high levels of economic activity and rapid economic growth, because it facilitates long-range planning by entrepreneurs and investors. The same reasoning applies to the stability of exchange rates.

The advocates of fluctuating rates implicitly recognize the validity of this argument when they insist that a system of flexible rates would not actually lead to large or violent rate fluctuations. In doing so, they admit that they are not prepared to rely on the price function of exchange rates to bring equilibrium to the international economy but that they advocate the pursuit of policies that would bring about equilibrium without any need for the exchange rates to change much. There is no economic advantage in formally permitting a price that is central to the organization of activity domestically and internationally to fluctuate when it is recognized that such fluctuations would be generally harmful to specific business and labor interests as well as to the public interest.

Cost and price rigidity

Advocates of flexible exchange rates contend that domestic costs and prices have become so rigid under present economic policies that exchange-rate fluctuations, in spite of any disadvantages, must be permitted to take over the adjustment function previously performed by changes in domestic costs and prices.

This contention, however, cannot be pressed very hard or far. Present-day Government policies are indeed designed to avoid a general decline of prices and incomes. But neither Government policies nor the resistance of business and labor to price and income declines can or do prevent individual prices in particular industries from declining. Similarly, Government policies designed to avoid a general increase in prices do not prevent individual prices from rising.

International trade arises in the first instance from cost and price differentials in particular export and import industries; and adjustments in these differentials are continually taking place. And if these industries are sufficiently important in the cost and price structures of individual countries, relative movements in the respective cost and price averages of these countries can and will occur.[3]

In the recent period, the impact of increased imports on U.S. costs and prices has been important in helping to restore competitiveness in various branches of U.S. industry, in curbing inflationary tendencies generally, and thus eventually in strengthening the U.S. balance of trade. Meanwhile, in surplus countries the inflow of foreign exchange and the bank credit and monetary expansion as well as increases in overall liquidity stemming from it has helped to raise aggregate

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[3] Between the average of 1957–59 (the base period of the wholesale price index of the Bureau of Labor Statistics) and March 1962, prices of the following categories declined by the percentages indicated: Man-made textile products 6.4, organic chemicals 6.7, plastic materials 8.3, automobile tires 12.9, warm-air furnaces 12, metal doors 5.1, electrical motors and generators 9.1, transformers and power regulators 12.4, household appliances 5, television sets, radios, and phonographs 8.7, glass containers 3.1, plate glass 10.8. For individual products, declines were often far larger (e.g., household and commercial refrigerators, 13.8).