domestic demand with a demand-pull effect on domestic costs and prices—and also on imports—more rapidly than in deficit countries.[4] While these movements have not yet occurred on a scale sufficient to establish balance-of-payments equilibrium among the countries concerned, they have clearly accorded with the postulates of gold standard theory.

Finally, under contemporary conditions of continuous advances in productivity, deficit countries do not need to follow policies that would keep wage rates and other cost elements from rising at all, nor do surplus countries need to pursue policies designed to foster increases in these costs. Provided that surplus countries permit costs to rise as much on average as productivity, international trade and payments adjustment can still take place through relative cost and price changes, provided costs rise less in deficit countries.[5] The essential trade and capital adjustments necessarily occur at the margin—in regard to products or services, including financial services, that are just on the verge of being competitive or noncompetitive internationally.

These considerations make clear that there continues to be a mechanism of marginal international payments adjustment through market processes under postwar conditions of managed currencies with fixed exchange rates. It needs to be emphasized that the mechanism of adjustment contemplated by gold standard theory also was activated by relative changes in costs and prices, as between deficit and surplus countries—and not by absolute increases and decreases in these elements. Thus, the postwar mechanism of adjustment does not differ in principle from the gold or gold exchange standard mechanism as conceived by theory and as relied upon in the past by leading industrial countries.

Destabilizing forces

Advocates of floating exchange rates underrate the risks to the international trade and financial position of a principal country from permitting rate fluctuations without clearly defined limitations. What, for example, would happen under present conditions if the United States adopted a flexible rate system?

The United States has been suffering for some time from a persistent international payments deficit. Unless the dollar exchange rate were fixed, this deficit would cause dollar depreciation in exchange markets. The resulting increase in the dollar price of imported and import-competing goods and services as well as of exports would put upward pressure on domestic costs and prices. This pressure would tend to frustrate current efforts to keep costs and prices under restraint.

If this happened, the market would sooner or later give up the expectation that the dollar rate might return to its previous level, and would count on further depreciation. Once market behavior became geared to such expectations, it could easily give rise to cumulative destabilizing movements of exchange rates, costs and prices.

The situation would be acutely aggravated by the large volume of liquid dollar assets—securities, money market paper, and time and demand deposits—held by foreigners. Foreign holders would try to liquidate the many billions of dollars of these assets before the depreciation of the dollar in terms of foreign currencies progressed. As a group, they would seek to sell or transfer marketable assets to others for cash which they would then offer against foreign currencies. This process would simultaneously generate upward pressures on interest rates (by depressing the price of securities and money market paper), disorderly markets for securities, strain on domestic bank reserve positions and a difficult problem for monetary policy, and a strong downward pressure on the dollar exchange rate.

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[4] Between 1958 and 1961, the trade surplus of the United States (as defined by the staff of the International Monetary Fund) rose by $1.5 billion while the combined trade deficit of the major industrial continental European countries (Austria, Belgium, Denmark, Germany, Italy, Netherlands, Norway, Sweden, and Switzerland—excluding France, which devalued its currency in 1958 and thereby turned a trade deficit into a surplus) increased by $1.4 billion (International Financial Statistics, August 1962, pp. 38–39).

[5] Between 1958 and 1961, wage rates (as defined by the staff of the International Monetary Fund) rose 10 percent in the United States. Of the continental European countries mentioned above, only three (Belgium, Italy, Switzerland) showed a similarly modest rise; in the others, the increases ranged from 16 to 30 percent (International Financial Statistics, August 1962, pp. 52, 56, 100, 120, 124, 168, 190, 202, 238, 242, and 270). While international comparisons of wage rates are subject to a wide margin of error, such large differences would appear to be significant.