

These developments would sharply reinforce expectations of a continued and perhaps accelerating decline in the external value of the dollar, and would accentuate expectations of rapid decline in the internal purchasing power of the dollar, originating in the rise in domestic prices of imports, import-competing, and exportable goods. Such expectations in turn would easily lead to hoarding of foreign currencies by domestic traders and speculators, which would further depress the dollar exchange rate and at the same time aggravate domestic financial disturbances. Abroad, these developments would also stimulate hoarding of gold and thus result in further drains on international reserves.

Two further special elements of the U.S. balance of international payments would add to the harmful effects of a depreciation of the dollar. First, those payments abroad for military expenditures and foreign aid that have to be converted into foreign exchange would have to be increased in terms of dollars, thus burdening the Federal budget. Second, expectation of continuous (whether fast or slow) depreciation of the dollar would make it ever more attractive for foreigners to borrow in the United States. Thus, the net outflow of investment capital and bank credit, at present already a major factor in unbalancing our international payments, would be further stimulated.

Risks of cumulative disturbances resulting from a variable exchange rate are greater for the United States than for most or all other countries, but to a lesser degree they would exist in any important trading country adopting a fluctuating rate. Seasonal and other short-run fluctuations in trade and capital movements could always produce larger fluctuations in exchange rates than would be appropriate for maintaining equilibrium in the long run.

The threat of cumulative exchange rate movements would be aggravated by the inflationary bias inherent in a system of variable exchange rates. If costs and prices were in fact generally characterized by resistance to downward rigidity, they would be expected to rise in countries with depreciating currencies but not to fall in countries with appreciating currencies. Since most countries would be expected to experience some measure of depreciation at one time or another, the forward expectation as to price and cost trends would everywhere be in the direction of rise. This expectation would produce an inflationary climate that might well be much more pronounced and pervasive than the alleged inflationary bias resulting from such fluctuations of monetary reserves as are likely to be experienced under a system of fixed exchange rates.

These considerations lead to the conclusion that some of the assumptions made by the advocates of fluctuating exchange rates are quite unrealistic. The "normal" responses to change in the price of a currency will often be not merely frustrated but actually perverted by the influence of expectations. And in order to protect themselves against the threat of cumulative effects of exchange rate fluctuations, countries would continue to feel compelled to hold sizable reserves (probably in gold); there is no reason to assume that these reserves would be smaller than they have to be under the present system of fixed exchange rates.

International constraints on domestic policy

International relations impose constraints on domestic economic policies regardless of the form of the international payments system. A country cannot achieve the goal of sustainable orderly growth if it continually pursues policies that tend to produce chronic deficits in its international payments. Under a system of fixed exchange rates, persistent deficits mean continued drains on the country's international monetary reserves. Under a system of fluctuating exchange rates, the disequilibrium instead means continual depreciation in the exchange value of the country's currency.

In either case, persistent tendency to external deficits will undermine a country's ability to maintain the volume of its imports of goods and services and its foreign lending, and thus retard its rate of growth. In either case, moreover, the process, unless checked by a change in domestic policies, is bound eventually to end in economic and financial crisis. Under fixed exchange rates, a country will run out of actual and potential reserves and be forced to devalue its currency, with disruptive effects on domestic and international commerce. Under freely variable exchange rates, depreciation of a country's currency will tend to progress continually, with domestic inflation propelled by the declining value of its monetary unit in international markets. It is an illusion, therefore, to suppose that reliance on the working of fluctuating exchange rates for adjust-