ment of international payments would reduce the constraints on domestic financial policies that exist under a system of fixed rates of exchange.

To clarify this matter, one needs to consider the nature of the constraints that are referred to in this connection. Under boom conditions, major goals of public policy are to prevent inflation in order to foster the sustainability of the economic growth process. For this kind of economic situation, fiscal and monetary restraints are clearly called for. If the balance of payments at such a time tends toward deficit, these policies are precisely the ones required to defend a fixed rate of exchange. Similarly, if a country is in recession while experiencing a tendency toward surplus in its balance of payments, no constraint exists on policies correctly designed to hasten recovery.

The constraints on domestic policies stemming from a fixed exchange rate system relate only to the case in which domestic activity is below desired levels, but the balance of payments is in deficit, indicating either that the country's competitive position needs to be strengthened or that for one reason or another capital investment at long term and short term inside the country needs to be made more attractive relative to capital investment elsewhere. In such a situation, undue emphasis on easy fiscal and monetary policies, without proper use of other measures available to a government, would not only worsen the balance-of-payments deficit, but, by weakening the country's competitive position for both exports and imports, would react unfavorably upon aggregate demand for the country's potential production.

It is asserted by advocates of floating rates that this constraint on policies designed to stimulate domestic demand would be significantly reduced under a system of variable exchange rates, because depreciation of the rate would counteract the worsening of the competitive position. But a country hoping to avoid constraints by means of continuing depreciation under a flexible rate system to counteract deterioration of its competitive position would soon find that the depreciation itself would tend further to weaken its competitive position: domestic costs and prices would continually move upward so as to offset the decline in the currency's external value. The result would be an interacting spiral of depreciation and domestic inflation, which would aggravate rather than relieve the country's international and domestic economic position. Finally, the country would feel obliged to adopt the constraining policies it had hoped to avoid. In fact, it would have to do so through a stabilization program, which would force abrupt adjustments that otherwise might have been accomplished in a more orderly and gradual fashion.

Official intervention

Some advocates of a system of fluctuating exchange rates concede the desirability of some official intervention to influence the abruptness and degree of fluctuation in international currency values. But intervention presupposes the availability of monetary reserves in foreign currencies. These reserves would be depleted if central banks, because of the uncertain exchange risk, did not retain the large amounts of dollars they now hold as reserves and working balances. As previously discussed, such a change, apart from contributing to dollar depreciation, would put great demand pressure on the limited supply of gold and its price. With limited annual accretions to the world's gold supply, and without the machinery for economizing gold provided by the present system of international reserve currencies, a floating rate system would lack adequate facilities to moderate exchange rate fluctuations in response to volatile and speculative flows of payments.

There are no established or conventional patterns of central bank behavior under variable rate conditions to provide a basis for any rules of the game for official intervention as envisioned by the advocates of a modified system of fluctuating rates. Without accepted ground rules, there would be a constant danger of countries using competitive exchange depreciation against other currencies to gain export advantages for domestic industry, and of engaging in other forms of conflicting exchange operations. As long as there is no agreement on the question of what these rules should be and how they should be established and enforced, there is little likelihood that official intervention could make a multiplicity of fluctuating rates, applying to developed as well as less developed countries, into an orderly system.