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AN ANALYSIS OF WHETHER OR NOT GREATER FLEXIBILITY IN FOREIGN EXCHANGE RATES WOULD SERVE IN THE INTERESTS OF UNITED STATES AND WORLD TRADE

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

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AT THE REQUEST OF
ABRAHAM RIBICOFF, *Chairman*,
SUBCOMMITTEE ON INTERNATIONAL TRADE

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"An Analysis of Whether or Not Greater Flexibility in Foreign Exchange Rates Would Serve in the Interests of United States and World Trade."

The question whether greater exchange rate flexibility is in the interests of U.S. and world trade can be assessed in terms of two somewhat different considerations:

—first, whether greater flexibility can contribute to a better world payments equilibrium and thereby to an atmosphere more conducive to a rational expansion of world trade free from governmental restriction or inducement; and

—second, a more technical question whether greater rate flexibility necessarily tends through increased risk to raise the cost of international transactions and thereby to reduce the volume of trade as compared with a system of "fixed" rates.

Our judgment is that the answer to the first question is positive. It is widely acknowledged that a major factor leading to the increasing instability and eventual collapse of the Bretton Woods monetary system was the failure of countries to implement effective and timely policies to moderate their balance of payments surpluses and deficits. It is also generally agreed that a major factor contributing to inadequate adjustment was the rigidity of the exchange rate mechanism and that greater exchange rate flexibility is a basic need of a reformed system. The United States strongly supports this view. More flexible exchange rate arrangements need not mean less stable exchange rates—a more adaptable exchange rate mechanism can contribute to a greater stability of the system as a whole.

The U.S. has presented comprehensive proposals to the Committee of Twenty—the group charged with negotiation of world monetary reform—which would provide strong and balanced incentives for adjustment of payments disequilibria and which incorporate provisions for more flexible use of the exchange rate mechanism. We believe that these proposals would greatly improve the process of balance of payments adjustment and provide a sounder and more stable basis for the development of U.S. and world trade in the future.

While the U.S. proposals assume that most countries will wish to maintain stable but adjustable par values for their currencies most of the time (which should be adjusted in a timely manner when they become inappropriate), they also recognize the contribution that more innovative techniques—wider margins of exchange rate fluctuation and floating exchange rates—can make toward an improved process of balance of payments adjustment. Specifically, the United States has proposed:

1. That wider margins of exchange rate fluctuation (on the order of the 2¼ percent margins agreed provisionally in the Smithsonian Agreement of 1971) be made a permanent feature of the system; and that these wider margins be available for use

by all countries, including the United States, in contrast to the arrangements in the past. We believe that arguments in favor of wider margins are persuasive, in particular:

(*a*) that they can help to discourage disequilibrating capital flows, thus absorbing pressures which would otherwise bring large changes in reserves and/or lead countries to impose controls on trade and payments;

(*b*) that they permit greater independence for national monetary policies by reducing the sensitivity of mobile capital to differences in money market conditions among nations; and

(*c*) that they can facilitate small changes in par value.

2. That countries be permitted to float their exchange rates, under appropriate international surveillance and agreed standards. Exchange rate floats can provide a useful means of responding to destabilizing capital flows, particularly in periods of pronounced exchange market uncertainty; greatly facilitate a transition from one par value to another, particularly where there is considerable uncertainty as to the appropriate level of the exchange rate; and provide a mechanism for payments adjustment more closely responsive to market forces over a more extended period.

With respect to the second question, we find no persuasive evidence that greater exchange rate flexibility has a damaging impact on trade. It should be noted that the term "greater flexibility" can cover various arrangements significantly different in technical detail. What the U.S. has proposed, and what is being discussed in the reform negotiations, is a system centered on stable but adjustable par values, with wider margins and provision for floating in particular circumstances. Neither a generalized freely floating exchange rate regime nor a system of "crawling exchange rate pegs" is envisaged as the result of reform or is under international discussion in the reform effort.

Nevertheless, the limited evidence available regarding the effects of more flexible exchange rates on trade relates primarily to experience with floating rates—the extended float of the Canadian dollar between 1950 and 1962, and the interim floating arrangements that were adopted by most industrial countries in mid-March 1973. Our analysis of the Canadian experience has produced no evidence that the flexible exchange rate regime adopted by Canada during 1950–1962 had an adverse impact on Canadian trade or that of other countries. Nor does the recent experience with widespread floating—although brief and under most difficult circumstances—lend support to the hypothesis that greater flexibility harms world trade. Such evidence as is available, while not conclusive for the longer run, suggests that the present transitional arrangements have not seriously affected, in one direction or another, the volume of world trade.

In conclusion, we believe that a reformed monetary system must yield more prompt, effective, and symmetrical payments adjustment than in the past. This is essential if we are to avoid the imbalances, uncertainties, and crises of recent years, and the tendencies toward damaging trade restrictions and protectionism which they produce. Greater flexibility of exchange rates—through wider margins and exchange rate floats, as well as more timely discrete changes in par value—is one essential element of an improved adjustment process and monetary system. Our judgment is that possible adverse technical effects of greater flexibility, if any, are outweighed by the benefits for U.S. and world trade to be derived from the contribution of more adaptable exchange rate arrangements to a smoothly operating process of balance of payments adjustment.