More Flexibility in Exchange Rates – And in Methods

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The following article provides an interesting and practical suggestion for improving the flexibility in international exchange rates. The article reflects Dr. Schmitz's personal opinion, and should not be interpreted as necessarily representing the official views of the Austrian National Bank.

Re-establishing the Bretton Woods Flexibility

Today there is widespread and growing understanding that it has become necessary to ease our exchange rate system, which has become too rigid, and to make the original Bretton Woods idea of sufficient flexibility effective again. The (short-term) transitional period of fluctuating exchange rates for the Deutsche mark has shown that in particular situations, a greater flexibility in the adjustment of exchange rates could be highly advantageous for the international monetary system.

In searching for ways and means to achieve more flexibility which, however, still would be a limited or controlled flexibility of exchange rates, there are two problems which now are to be investigated separately:

1) Which technique for more flexibility is best suited for specific situations; and
2) What should be changed or amended in the Articles of Agreement of the IMF so that those methods may be employed legally?

This article deals primarily with the second question.

Why More Flexibility of Exchange Rates?

There are quite different motives for calling for more flexibility in the exchange rates:

It should be made easier for governments to adjust exchange rates as it has been envisaged by the Bretton Woods System, but in fact practiced only hesitatingly. The postponement of the devaluation of the French franc from November 1968 (Bonn Conference of the Group of Ten) to August 1969, and the delay in the revaluation of the Deutsche mark until September 1969, brought France a heavy loss in its international reserves and thus severe exchange restrictions to the business community, and brought Germany an undesired and inflationary influx of foreign exchange.

As long as there is not sufficient international coordination of economic and monetary policies, the rigidity of exchange rates will continue to cause inflationary or deflationary currents to flow from one country to another. More leeway in the adjustment of exchange rates could better enable countries to protect themselves against this. More flexible exchange rates would facilitate a more effective use by central banks of their monetary policy instruments to regulate the money supply of their countries in the face of balance-of-payments influences.

In 1951 the IMF was already concerned with the issue of more flexibility: "The maintenance of a given exchange rate sometimes is made very difficult either by a set of internal policies or by the external economic forces with which countries must deal. In the main, these difficulties arise from the fact that changing economic forces operate with unequal effects on various countries."[1]

Under a dollar standard, large industrial countries or groups of industrial nations could have the intention not to link, unconditionally and automatically, their monetary policies to that of the U.S. authorities. More flexibility in exchange rates would enable those countries to keep their price levels stable even if the United States is not successful in fighting inflation.

The present system of abrupt and not easily reversible alterations of exchange rates favors speculation because there are no serious financial risks to being wrong. An increased flexibility in the formation of exchange rates will increase the risks and there-

[1] *Annual Report,* International Monetary Fund, Washington, D. C., 1951, p. 37.

fore should produce more success in combatting speculation.

In view of the priority accorded to aims of national economic policy (e.g. monetary stability, full employment, economic growth), the equilibrium of the balance of payments is often neglected. More flexible exchange rates could facilitate, without jeopardizing the national policy goals mentioned, the balancing of international payments.

How to Get More Flexibility?

Since there are different motives underlying the call for more flexibility, several proposals to introduce more flexibility into the exchange rate mechanism have been made.

The members of the IMF are advised to make more frequent use of the present provisions of the Articles of Agreement by adjusting their exchange rates more often but by smaller steps.

One step further is the proposal to allow exchange rates to drift slowly and steadily by weekly, monthly or quarterly alterations up to a maximum annual rate of 2 to 3 per cent, either automatically or guided deliberately (crawling peg – sliding parity). Such limited exchange rate flexibility is believed to be small enough to discourage speculation in foreign exchange markets, while assuming enough stability for international trade and payments, and providing sufficient scope for long-run exchange rate adjustments.

Another way to make the system more flexible would be to widen the limits within which exchange rates are allowed to fluctuate around their par values. It is suggested to increase the present margin of 1 per cent on either side of parity to about 2 to 3 per cent (smaller band) or about 4 to 5 per cent (broader band).

A combination of the "sliding parity" ("crawling peg") proposal with a widening of the margins is known as a "movable band."

Another solution of exchange rate flexibility has been chosen by Canada and Germany outside the Articles of Agreement of the IMF: freely or manipulated floating exchange rates limited to a single country and/or to a certain period of time.

With regard to the inter-relationship of economic integration and exchange rate stability, the proposal has been made to establish currency areas, each comprising a group of countries. Between such areas, exchange rates would be freely, or within limits, variable; within each group of countries parities would be fixed without any adjustment procedure, because of the close economic integration and cooperation.

More Flexibility in the Methods

In the discussion on the optimum technique to be followed in order to achieve better flexibility, these instruments have been considered so far. Nevertheless, it seems difficult to recommend the use of one particular technique for all situations, as the motives calling for smoother adaptation are manifold, and it might be difficult to find any one device appropriate in all cases. The crawling peg proposal, especially the asymmetric upward type providing for only an upward movement, for instance, may be appropriate for offsetting differences in the rate at which different countries' cost levels are rising; there are, however, doubts whether it really would discourage speculation. The "widening of the margins" proposal, within which exchange rates are permitted to fluctuate around their par values, would not solve the problems created by long-run disparities of inflation rates in different countries; it would deal effectively with short-run disturbances and, by making possible losses as well as gains, would be able to curb speculation in foreign exchange. Wider bands may be suitable to avoid the risk of irreversibility of changes in parity, and thus would make it easier to adjust an exchange rate in a way that, after the intervention point had been reached, the rate might later on be declared as the new parity. "Floating rates" (freely or manipulated) anticipating exchange rate adjustments are a device to avoid a period of speculation as was the case in the recent Deutsche mark crisis last September. Moreover, there will be cases where the *more frequent use of the present provisions* may be suitable under certain circumstances. In many cases, the present adjustable peg will still remain the best way to adjust a parity also in the future.

We should, therefore, be more flexible also in choosing the method of achieving more exchange rate flexibility. It should be proved whether it *would not be wise to leave the choice of the appropriate instrument to the discretion of the Fund (IMF), in close consultation with the countries concerned.*

Proposed Amendment to the Articles of Agreement

According to the currently valid provisions of Article IV, the suspension of a par value established in concurrence with the Fund is not permitted, unless a new par value is agreed upon forthwith. If, however, under exceptional circumstances, a country cannot maintain the agreed parity, or the establishment of a new parity or the adherence to the margins prescribed involves considerable risks, that country may so inform the Fund and state that it will temporarily not be in a position to fulfill the obligations of Article IV, Sections 3 and 4. If the Fund concludes that the arguments presented are convincing, it may make its view known, but it cannot approve of the action of the member country. Also, it is not clear whether the Fund, based on the policy it has evolved over time, may in the course of consultations with member countries recommend changes in the par values of their currencies. The power of the Fund to effect parity changes by action under the exchange rate provisions of the Articles is strictly limited to responding to proposals made by members. If there is no proposal on the part of the member, the Fund has no power under these provisions to induce action with respect to a member's parity. It is generally considered that the Fund is not regarded as being authorized to recommend to a member to employ certain techniques of more flexibility, even in cases when such a procedure would protect the international monetary community (e.g. the Deutsche mark case in the fall of 1969).

In order to terminate this legally unsatisfactory situation which, incidentally, restricts the influence the Fund may exert on such special situations. Article IV could perhaps be amended by the insertion of a new paragraph. It would empower the Fund to approve or suggest, in close consultation with the country concerned, the temporary introduction of an exchange rate formation deviating from the present wording of Article IV, if such a step for the country concerned appears justified in the light of prevailing (specific) circumstances.

The admission or suggestion of one or another system of limited flexibility could be based on the following criteria:

1) Circumstances must be of a character that more flexibility is deemed appropriate to avoid disturbances in international money markets;

2) The decision is to be made by the IMF in close contact with the member concerned.

Strengthening the Authority of the IMF

Payments restrictions were introduced by member states, though they are regarded by Article I of the Articles of Agreement as measures destructive to national or international prosperity. Important decisions, as for instance allowing exchange rates to fluctuate, were not permitted by the Fund for lack of legal possibilities, but had to be tolerated. These circumstances, in some quarters, led to the opinion that in the long run the authority of the Fund may be weakened. If we aim just at maintaining the regime of rigid rates as it stands now, we run the risk of putting at stake both of the most important achievements of our present international monetary system: the convertibility of important currencies, and the authority of an international monetary institution. We should keep in mind that the merit of Bretton Woods is not only the achievement of having established a system of fixed par values, but above all, the fact that it was successful in setting up an international organization to take care of the interests of the world's monetary community.

It would strengthen the authority of the IMF if the decision on which method to choose for achieving more flexibility would be left not just to the country concerned, as practiced at present, but also to the Fund. This would put the Fund into the position to base its decision, if desirable, on certain conditions regarding the economic policy of the country concerned. The Fund even would be able to encourage exchange rate adjustments. Thus exchange rate policy may, together with a set of other suitable instruments, play its proper role in the adjustment process.

Other Advantages of the Proposed Solution

It is unlikely that there will ever be general agreement on an optimal method of flexibility applicable to all cases. The amendment of the Articles of Agreement as proposed here could, however, within a relatively short period of time, be presented to and examined by the Board of Governors of the IMF and recommended to the member countries for adoption.

The IMF could then be in a position to take into account the special features of a given situation and choose the method best qualified to deal with it in close consultation with the country concerned.

It is not very likely that more flexibility leads to frequent fluctuations of the exchange rate. Even those countries that have embarked on a policy of fluctuating rates have in practice generally stabilized their rates within narrow limits over long periods of time. Under the provisions suggested in this paper, the IMF furthermore would be able to control that policy.

As the fate of the exchange rate system of Bretton Woods demonstrates, it is difficult to foresee the attitudes of governments, central banks, the business community and the public towards new international regulations. If necessary, a change in the policy of the IMF is relatively easy to affect. The various methods for improvement of flexibility could make it possible to gain new experience. The system of limited flexibility can be based on lessons learned from experience gained in the pure par value system as well as from new experiments.

Such an amendment would provide for the smallest change of the present system. There would not be any direct changes concerning the majority of countries not in need of increased flexibility at present. And for those countries which, for whatever reasons, shun adjustment of their par value by the current method of the adjustable peg, there would be a variety of other methods.

A greater flexibility within determined or determinable limits is not only compatible with the general principle of fixed exchange rates – the maintenance of the present system even makes solutions for special cases necessary. Limiting flexibility as to space and time should allay the doubts of those who, rightly or wrongly, fear the introduction of new factors of uncertainty into the international monetary system. On the other hand, such a solution will also permit the further evolution of those new methods which prove to be useful.

The proposed amendment finally is compatible with a general widening of the bands, if the IMF study comes to the conclusion that it would be useful.

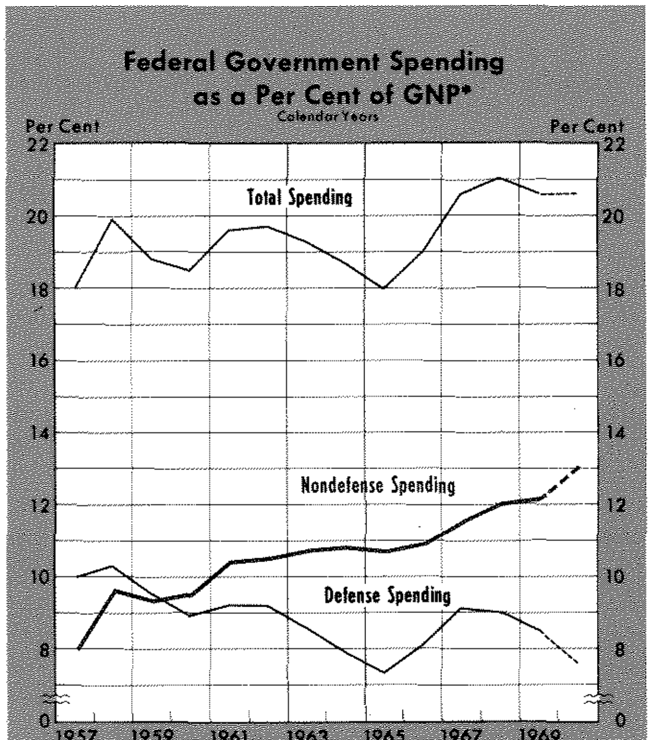
Extent of the Slowdown — *(Continued from Page 5)*

ten months ending May 1960. Fiscal actions remained restrictive for more than a year after the recession began. Money, however, began rising within two months after the recession commenced. The 1960-61 recession was probably the mildest of the three periods of adjustment considered here; total spending evidently responded to the moderate monetary expansion in spite of a large high-employment surplus.

1969— Fiscal actions changed from a stimulative to a restrictive stance more than a year before August 1969, reflecting the 10 per cent surtax imposed in mid-1968 and some cuts in the rate of Government spending growth. The high-employment budget moved from a large deficit in early 1968 ($14 billion annual rate) to a surplus ($8 billion annual rate) in the third quarter of 1969. However, it may be noted that the surplus after mid-1969 was far less in relation to total spending than in the 1961-63 period, when the nation recovered from recession.

According to the plan outlined in the President's current budget, fiscal actions are to remain moderately restrictive through 1970. The high-employment budget in the first half of the year is estimated to remain near the $9 billion rate of surplus level reached in the last half of 1969 and then rise to about a $13 billion rate in the last half of 1970. Social security outlays are scheduled to increase in the second quarter, and the tax surcharge is scheduled to expire in July, but these expansionary actions are to be more than offset by curtailment in the growth of Government spending.

The influence of the Government on total spending may turn out to be moderately expansionary in 1970. Attainment of fiscal restraint is dependent on the willingness of Congress to limit spending to the amount proposed in the high-employment budget plan. Also, even if the plan is followed and the economy weakens, tax receipts may be less than anticipated in the plan, causing the unified and national income accounts budgets to indicate a more expansionary effect on the economy. According to one view, this automatic stabilization feature of Government



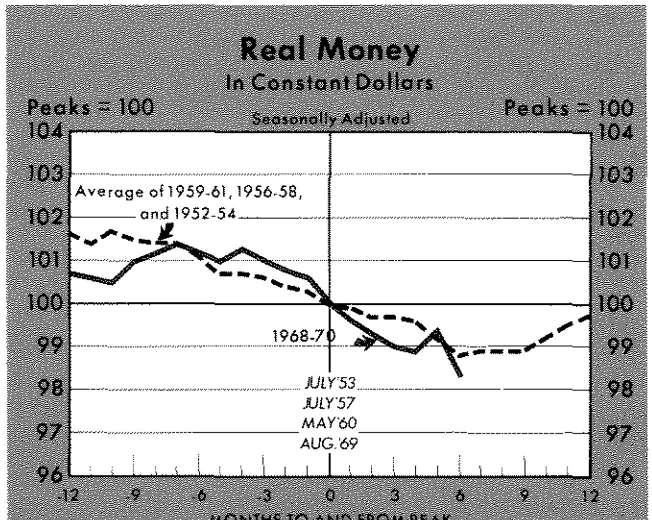
*National Income Accounts basis. Source: U.S. Department of Commerce
Latest data plotted: 1969 preliminary; 1970 estimated by Federal Reserve Bank of St. Louis

tax receipts tends to have a desirable stabilizing effect on total spending, and accordingly would not be reason for alteration of the high-employment budget plan.

Defense spending is expected to decline from 9 per cent of total spending in 1967 and 1968 to 7.5 per cent in 1970, while the nondefense portion of total spending is planned to rise from 11.5 per cent in 1967 to 13 per cent in 1970.

Monetary actions were only moderately restrictive before August 1969. In the seven months ending with August, money rose at a 2.8 per cent annual rate. This was faster than immediately before any of the three recessions reviewed, but was considerably less than the rapid 7 per cent rate of increase during the preceding two years. From last August to February money rose at less than a 1 per cent rate, which is faster than in the first six months after the 1957 peak and about the same as after the 1953 and 1960 highs.

Adjusted for declines in the purchasing power of money, monetary actions have been similar to those around other recent cyclical peaks. Money in real terms declined at a 2.3 per cent annual rate in the seven months before August 1969 and at a 3.5 per cent rate in the first six months after August. In the corresponding seven months before the three previous



Latest data plotted: February estimated

business cycles, the average contraction of money in real terms was also at a 2.3 per cent rate, and in the six months after the turn the contraction was at a 2.4 per cent rate.

Conclusions

Is the economy in a recession or in a pause? The answer to this question cannot be conclusively settled at this time (early March). Complete interpretation of recent and current events depends on developments in the near future. However, evidence is growing that real output is continuing to decline in early 1970, and that the late-1969 to early-1970 period may ultimately be termed a recession.

A review of widely used economic measures through the months of January and February shows some similarities between the current situation and the three previous recessions, but most yardsticks indicate that the slowdown has been milder than in the early months of the three most recent recessions. On the other hand, the current hesitation already appears to be slightly greater than the 1962 and 1967 pauses in economic activity, neither of which was severe enough to be termed a recession.

Whether the current downturn remains milder than the earlier recessions, matches them, or becomes more severe depends on many factors. The course of developments in the economy over the rest of the year will be influenced by recent and forthcoming Government stabilization actions. Recent fiscal actions have been moderately restrictive, and are expected to change only slightly in the near future. But in the past, fiscal actions alone have not been consistently related either to recession or expansion. For example, the mini-recession of early-1967 occurred when fiscal actions were the most stimulative in over two decades, and total spending continued to rise rapidly in late 1968 and early 1969 despite a sharp shift toward fiscal restraint.

Monetary actions have also been moderately restrictive, but less so than during the corresponding periods around any of the three previous cyclical peaks. From December 1968 to February this year money rose at a 2.1 per cent annual rate. By comparison, money declined at a 0.3 per cent average rate in the corresponding 14-month periods around the three previous peaks. Assuming money has begun rising at a moderate rate, past experience suggests that the current "recession" will be the least severe of any in the past two decades.

Along with the interruption in production growth, the country continues to suffer from continued inflation. The inflation was caused by excessive spending, stimulated by expansionary fiscal and monetary developments from 1964 through 1968.[1] Despite a slowing in the growth of spending in late 1969 and early 1970, the rate of overall price increase has continued at about the 5 per cent rate attained in early 1969. Some prices were held back during the period of excessive spending by regulations (for example, public utility rates), by contracts (prices of some materials and labor services), and by public opinion or a money illusion. As these prices move up, they place cost-push pressures on some other prices, causing inflation to continue after the excessive spending is eliminated.

Experience indicates that inflation can be eliminated only slowly, and that success in reducing it will take great patience and the avoidance of excessive policy actions. During the recessions of 1958 and 1960, price increases continued despite a pronounced reduction in demand for goods and services. Whether and how soon the inflation will now be eliminated depends on many factors, such as avoidance of strongly expansionary fiscal or monetary actions, correction of imbalances from past actions, and the atrophy of expectations of further price advances.

[1]See Norman N. Bowsher, "1969-Battle Against Inflation" in the December 1969 issue of this *Review*, pp. 2-12.

This review of previous recessions indicates that long-term interest rates tend to recede slowly. Yields on highest-grade seasoned corporate bonds averaged about 7.8 per cent in the three months ending with February. Price expectations have been a major factor affecting the level of interest rates.[2] When borrowers expect prices to rise, they are willing to pay higher interest rates, because equipment and materials will cost more later. Any stimulative effect of higher rates on saving is offset by anticipated future reductions in the purchasing power of funds. In previous recessions long-term rates drifted lower only slowly as inflationary expectations receded. In the 1957-1958 period, for example, interest rates on highest-grade corporate bonds decreased from a peak average of 4.1 per cent in the third quarter of 1957 to a trough of 3.6 per cent three quarters later. These interest rates fell from a high of 4.6 per cent in the last quarter of 1959 to a trough of 4.3 per cent in the first quarter of 1961. Short-term rates in each recession declined more sharply than long-term rates.

In summary, the economic pause since last August has been milder than during the three previous recessions. Experience from previous periods when the growth rate of money has slowed indicates that the contraction may go on for a quarter or more, and that continued monetary restraint would intensify the magnitude and duration of the downturn. On the other hand, if progress is to be made in moderating the rapid increases in prices, excessively rapid increases in money, such as occurred in 1967 and 1968, must be avoided.

[2]See William P. Yohe and Denis S. Karnosky, "Interest Rates and Price Level Changes, 1952-69" in the December 1969 issue of this *Review*, pp. 18-38.