

FEDERAL RESERVE BANK OF ST. LOUIS

MARCH 1970



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Extent of the Slowdown

by NORMAN N. BOWSHER

SPENDING growth has slowed in recent months; production has stagnated or declined. Total dollar spending on goods and services rose at about a 4 per cent annual rate from the third to fourth quarter of 1969, compared with an average 8 per cent rate from 1965 to the fall of 1969. Spending probably rose yet more slowly in early 1970. Real production of goods and services declined slightly from the third to fourth quarter last year, and the decline probably accelerated in early 1970. From mid-1968 to the fall of 1969, real output had risen at a 2.8 per cent rate, and 5 per cent in the previous year.

Other measures of economic performance have also shown weakness in recent months. Industrial production has declined at a 5 per cent annual rate since last July, after rising about 5 per cent in the previous year. Payroll employment was about unchanged from last October to February. Unemployment, which averaged an unusually low 3.5 per cent of the civilian labor force last summer, rose to 4.2 per cent in February. Unemployment among married men rose from 1.5 per cent to 2 per cent.

Despite the marked slowing in the growth of spending and the cutbacks in production, prices have continued to rise at about the same pace as in early 1969. Although the rate of increase of the general price index (GNP price deflator) ostensibly slowed somewhat to a 4.7 per cent annual rate in the fourth quarter, it rose at a 5 per cent rate during the last half of 1969, the same rate as during the first half of the year.

An evaluation of current trends in economic developments cannot be completed for many months. Meanwhile, some insight may be gained by comparing recent developments in the chief economic measures and public policies with their behavior around peaks in economic activity in previous postwar cycles. The last three peaks in economic activity selected by the National Bureau of Economic Research are May 1960, July 1957, and July 1953. Comparison of the current situation with these periods may be helpful in providing perspective on the magnitude of the current downturn and in developing judgments about its possible future course.

Selecting a recent "peak" month or quarter for comparison is arbitrary at this time. Housing starts

reached a high about a year ago. Other measures, including industrial production, reached their peaks last summer, while others, such as construction, reached highs in the fall. A number of dollar-amount time series, including personal income, have continued to rise, but at a reduced pace. In this study August 1969 is used as a tentative peak. It is the middle month of the quarter when total real output of goods and services was greatest. Any other month from last July to November might have been selected.

Comparisons with Previous Cycles

Spending growth in recent quarters has been considerably faster than around the previous three cyclical peaks. In the year ending with the third quarter 1969, total spending on goods and services rose 8 per cent (Table I). This was greater than for the corresponding period preceding any of the other peaks. The average for the last year of the three previous economic upswings was 5 per cent.

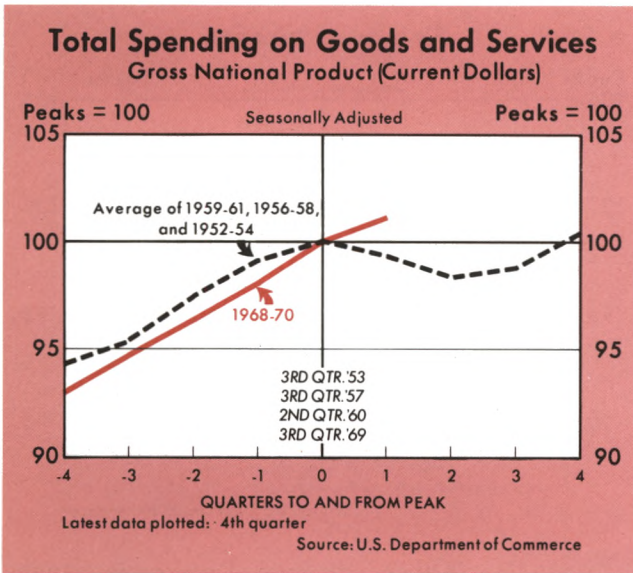
From the third to the fourth quarter last year, total spending rose at a 4 per cent annual rate. In

Table I

CHANGES IN PRODUCTION AND SPENDING
(Annual Rates of Change)

Peak Quarter of Economic Activity	Total Spending ¹	Total Production ²
	Year Before Peak	
III/1969	7.6	2.5
Recessions:		
II/1960	3.7	2.0
III/1957	6.1	2.4
III/1953	5.9	5.0
Average of 1960, 1957, and 1953 peaks	5.2	3.1
Slowdowns: ³		
IV/1966	8.5	4.9
III/1962	7.7	6.4
	Quarter After Peak	
III/1969	4.0	- 0.4
Recessions:		
II/1960	- 0.4	- 1.9
III/1957	- 4.2	- 6.0
III/1953	- 5.3	- 4.7
Average of 1960, 1957, and 1953 peaks	- 3.3	- 4.2
Slowdowns: ³		
IV/1966	1.8	- 1.0
III/1962	5.5	3.7

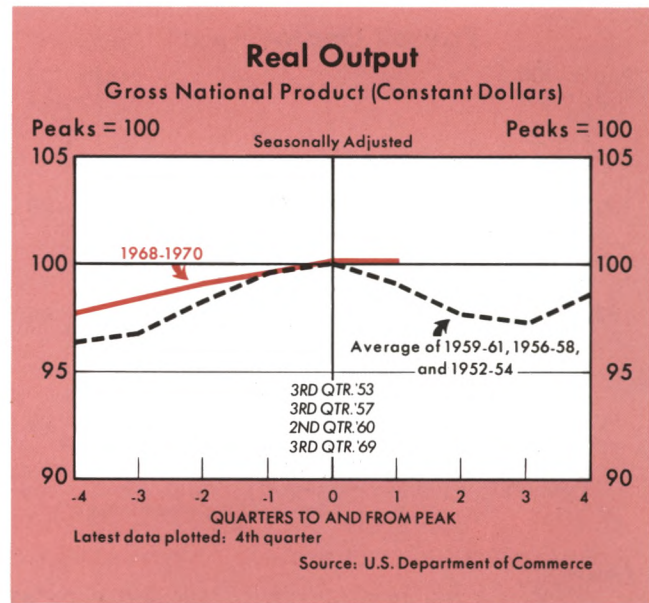
¹Gross National Product in current dollars
²Gross National Product in constant dollars
³Slowdowns selected by Federal Reserve Bank of St. Louis.



the first quarter of each of the three previous business recessions total spending declined at an average 3 per cent rate. Preliminary data indicate that total spending probably continued to rise moderately from the fourth quarter last year to the first quarter this year. In the second quarters of the three previous recessions, total spending declined at an average rate of 4 per cent.

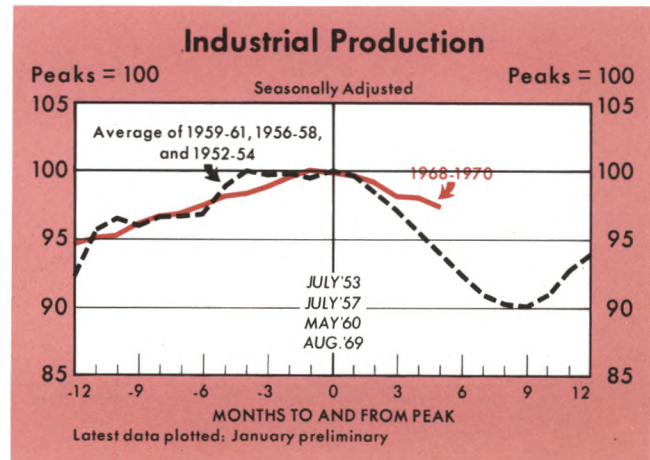
The more rapid growth of spending in 1969 and early 1970 than around previous cyclical peaks reflects the higher rate of inflation in the current period. In real terms, the recent and earlier periods are more nearly similar. Real production before the assumed peak last August grew somewhat slower than before other peaks, but it has demonstrated more strength after the turn than during the early months of the three previous business recessions. In the year ending with the third quarter of 1969, total output of real goods and services rose 2.5 per cent, compared with an average 3.1 per cent in the corresponding years before the 1960, 1957, and 1953 peaks (Table I). From the third to fourth quarter in 1969, production declined at a 0.4 per cent annual rate, while in each of the first quarters after the three previous cyclical turns, output declined much more sharply, averaging a 4.2 per cent annual rate.

Industrial production, which includes only about one-third of total production but which is measured monthly, has followed a pattern similar to total real output. In the eight months ending last August, industrial production rose at a 5 per cent annual rate (Table II), about the same as the average for the eight months before the 1953, 1957, and 1960 business cycle peaks.



The decline of industrial production at a 6 per cent annual rate from August to January was much more modest than in the comparable 1957 and 1953 periods, and about the same as in the 1960 period. Production fell at an average 14 per cent rate in the corresponding five months of the three previous recessions.

Employment trends have been much stronger in 1969 and early 1970 than around the upper turning points of the three earlier business cycles (Table II). From December 1968 to August 1969 payroll employment rose at a 3.6 per cent annual rate. In the comparable eight months preceding each of the three previous business cycle peaks, the growth rate of payroll employment averaged 2 per cent. Since last August payroll employment has risen slightly, at a 0.5 per cent rate, whereas in the first five months of each of the three previous recessions, it had declined, at an average annual rate of 2.8 per cent.



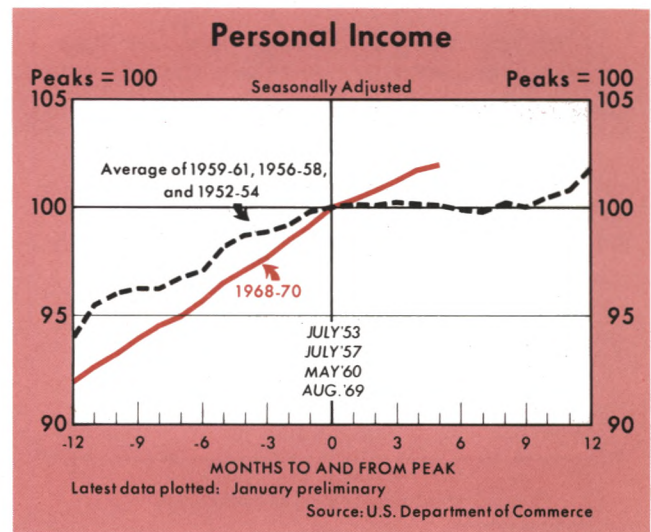
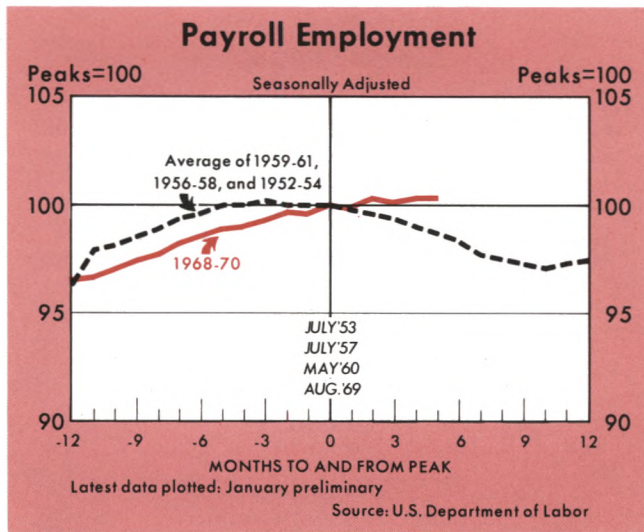
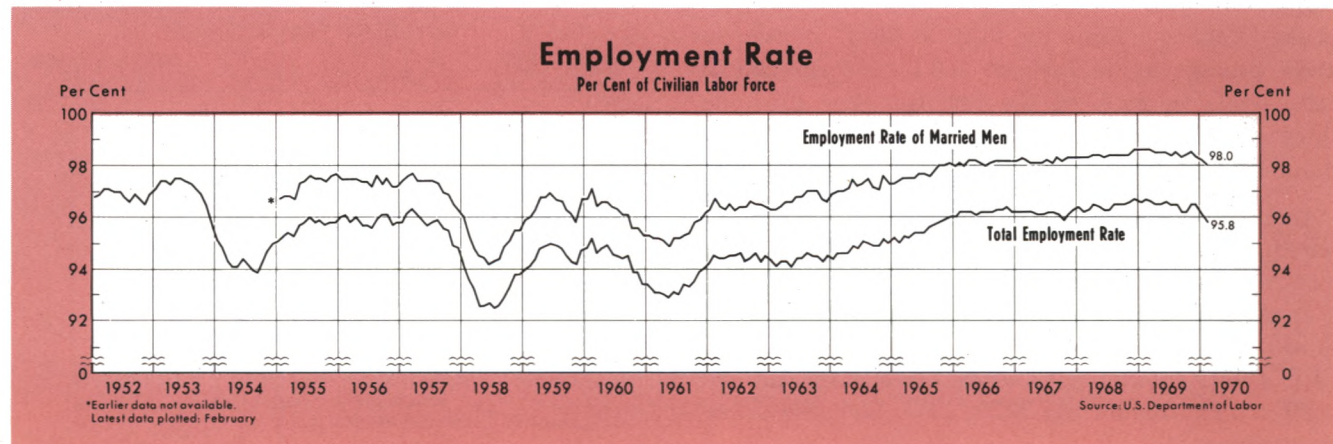


Table II
CHANGES IN SELECTED ECONOMIC INDICATORS
(Annual Rates of Change)

Peak Month Of Economic Activity	Industrial Production	Payroll Employment	Personal Income	Construction Expenditures
Eight Months Before Peak				
August 1969	5.0	3.6	8.8	6.5
Recessions:				
May 1960	8.6	3.1	7.0	- 2.1
July 1957	1.0	0.7	5.5	1.1
July 1953	6.2	2.1	5.2	4.2
Average of 1960, 1957, and 1953 peaks	5.3	2.0	5.9	1.1
Slowdowns:				
October 1966	7.0	4.5	8.2	- 6.8
July 1962	5.4	2.9	5.2	5.8
Five Months After Peak				
August 1969	- 6.0	0.5	5.0	- 3.4
Recessions:				
May 1960	- 6.2	- 1.7	1.9	- 2.2
July 1957	- 16.1	- 3.1	- 0.1	2.2
July 1953	- 19.5	- 3.5	- 1.4	0.6
Average of 1960, 1967, and 1953 peaks	- 13.9	- 2.8	0.1	0.2
Slowdowns:				
October 1966	- 4.2	2.8	6.6	.3
July 1962	.8	1.1	5.1	- .8

Other indicators of economic activity, both nominal and real, generally confirm the evidence emerging from the above measures that the economy has been stronger in the past than at periods around the three previous cyclical peaks. Personal income rose more rapidly immediately before and after August 1969 than in the like periods around May 1960, July 1957 and July 1953. Construction expenditures, which were adversely affected in the past year by financial disintermediation, nevertheless compare favorably with expenditures over the entire period before and after the earlier cyclical peaks (Table II). About 96 per cent of those in the labor force were employed in early 1970, while at the same stage in the three previous recessions the employment rate averaged about 94 per cent.

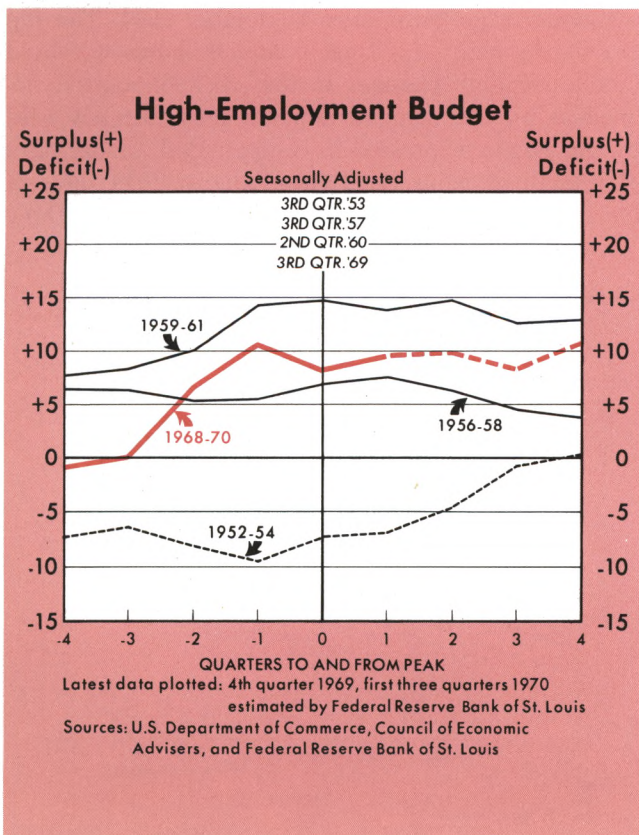


Inflation is also much stronger now than around the earlier cyclical highs. Overall prices rose 5.1 per cent during 1969. In the comparable years ending one quarter after the three previous business highs, overall prices rose an average 1.6 per cent.

Fiscal and Monetary Conditions

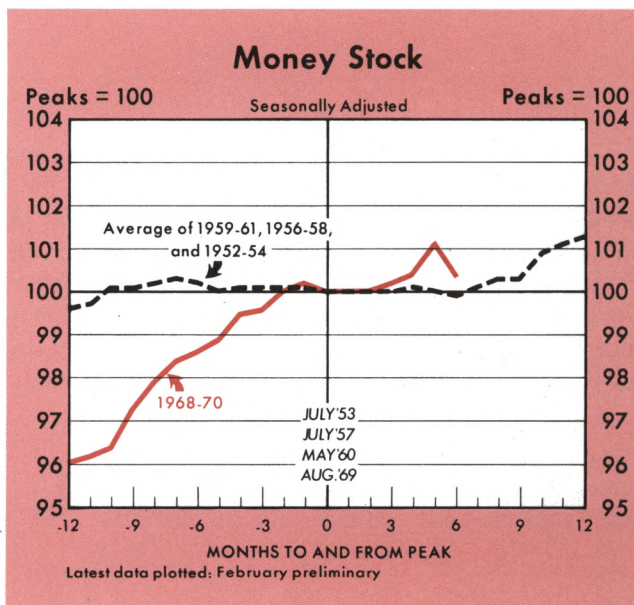
A brief review of recent Government economic stabilization actions, compared with those around the beginnings of the last three business recessions, may also be useful in evaluating recent business developments. Fiscal conditions, as measured by the high-employment budget, were nominally stimulative prior to the July 1953 peak and restrictive before the July 1957, May 1960, and August 1969 high points. Monetary actions, as measured by changes in the money supply, were restrictive prior to each of the four peaks.

1953— Around the July 1953 turning point in business activity, fiscal actions were stimulative while monetary developments were moderately restrictive. The budget was in large deficit as a result of the Korean conflict, but in the peak quarter it was somewhat less stimulative than in the previous quarter. Immediately after the peak, fiscal actions became less expansionary, with cutbacks in spending after the Korean War more than offsetting lower tax rates.



The money stock increased at a 1.6 per cent annual rate in the seven months before the July 1953 peak. This was much slower than the 4 per cent rate from 1949 to 1952. After the peak in business activity, money changed little on balance for a relatively long period of nine months before it began rising rapidly. The recession of 1953-54 was the longest of the three considered, and illustrates that a downturn can occur despite a stimulative Federal budget.

1957— Around the July 1957 peak both fiscal and monetary developments were restraining forces. The high-employment surplus was slightly restrictive, moving up \$2 billion in the two quarters before the peak and remaining at about this level for two quarters afterward. Thereafter, the budget became somewhat less restrictive.



Seven months before the 1957 turning point, the money supply reached a plateau and remained at this level until two months after economic activity began contracting. From the second to the sixth month of recession, money contracted at a 3 per cent rate. After the sixth month of recession, however, money rose at a rapid 5 per cent rate in the following five months. By most measures the 1957-58 recession was the most severe of the three examined, but its subsequent recovery was also the most pronounced.

1960— Before the cyclical peak of May 1960, both fiscal and monetary conditions were very restrictive. In the year ending with the peak quarter, the high-employment surplus rose from \$8 billion to about \$15 billion, a high level by historical standards. Money contracted at a 3 per cent annual rate during the

(Continued on Page 14)

Money Supply and Time Deposits, 1914-69

IN SEPTEMBER 1964 an article in this *Review* discussed the relation between money supply, time deposits, money plus time deposits, and periods of national economic contraction and expansion. In particular, the historical data were reviewed in light of the hypothesis that an increase in growth of the money supply or some other specific monetary magnitude, relative to growth of the demand for it, would result

in a rise in total spending. Conversely, a reduction in the growth of this key variable, without a corresponding decline in the growth of demand for it, would cause a decline in spending.

This note, with accompanying charts and tables, re-evaluates the earlier conclusions in light of the additional experience since September 1964. The top tier of the chart on pages 8 and 9 shows weighted month-to-month changes in the stock of money, defined as private demand deposits plus currency held by the public, expressed in compounded annual rates of growth or contraction from August 1914 through December 1969. The middle and bottom tiers show

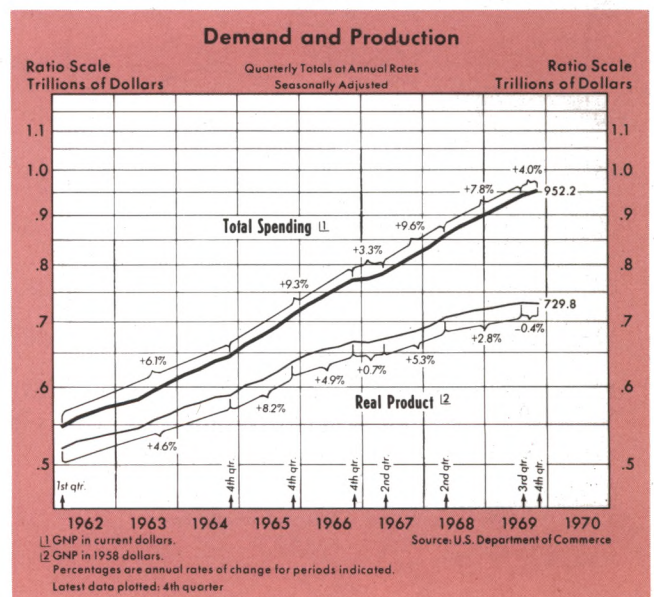
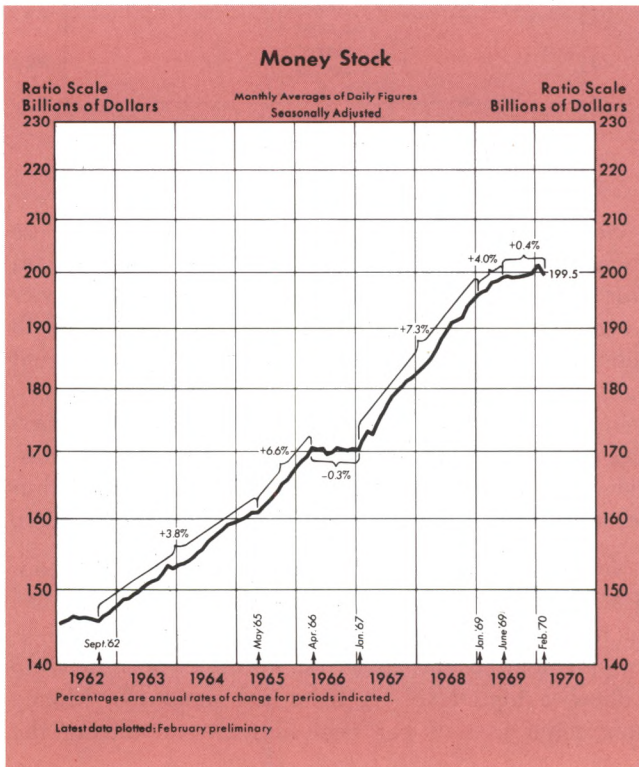


Table I

PERIODS OF CONTRACTION
National Bureau of Economic Research

Peak	Trough	No. of Months
Jan. 1913	— Dec. 1914	23
Aug. 1918	— March 1919	7
Jan. 1920	— July 1921	18
May 1923	— July 1924	14
Oct. 1926	— Nov. 1927	13
Aug. 1929	— March 1933	43
May 1937	— June 1938	13
Feb. 1945	— Oct. 1945	8
Nov. 1948	— Oct. 1949	11
July 1953	— Aug. 1954	13
July 1957	— April 1958	9
May 1960	— Feb. 1961	9

PERIODS OF MARKED SLOWDOWN
Federal Reserve Bank of St. Louis

Peak	Trough	No. of Months
July 1962	— Dec. 1962	5
Oct. 1966	— April 1967	6
Aug. 1969	— *	*

*Specification of the end of the latest slowdown was not clear at the time of this publication.

similar data for time deposits and money plus time deposits, respectively. The shaded vertical columns on the chart, 1914-1961, denote periods of economic contraction as determined by the National Bureau of Economic Research, and the shaded vertical columns, 1962-1969, denote periods of economic slowdown as selected by this bank. The initial and terminal dates for all but the current slowdown are presented in Table I. The horizontal bars on the chart represent the trend rates of change for periods of no marked and sustained change in the rates of change of the variable. Although selection of periods is judgmental, it is believed that most analysts would arrive at substantially similar results. The average annual rate of change for each selected period is presented in Table II for money, in Table III for time deposits, and in Table IV for money plus time deposits.

Experience since 1964 has been similar to that in the 1914-64 period. That is, marked and sustained changes in the rates of growth in either money or money plus time deposits have usually been followed after a brief lag by changes in the same direction in the growth of total spending. With respect to the hypothesis tested, this would seem to indicate that increases and decreases in the supply of these magnitudes, rather than being in response to changes in the

Table II

MONEY SUPPLY¹
COMPOUNDED ANNUAL RATES OF CHANGE
(Seasonally Adjusted)

Periods of No Marked and Sustained Change in Rates of Change (represented by bars on chart)	Annual Rates of Change
June 1914 — Dec. 1969	5.3%
June 1914 — Dec. 1917	14.2
Dec. 1917 — Feb. 1919	8.2
Feb. 1919 — March 1920	17.4
March 1920 — Jan. 1922	8.2
Jan. 1922 — Jan. 1923	11.0
Jan. 1923 — April 1924	0.5
April 1924 — Sept. 1925	10.3
Sept. 1925 — Dec. 1926	2.5
Dec. 1926 — April 1928	3.3
April 1928 — Sept. 1929	0.4
Sept. 1929 — March 1931	4.2
March 1931 — July 1932	14.3
July 1932 — Aug. 1933	4.8
Aug. 1933 — June 1936	16.7
June 1936 — March 1937	6.5
March 1937 — Dec. 1937	8.4
Dec. 1937 — June 1939	7.9
June 1939 — June 1942	17.9
June 1942 — Dec. 1943	30.8
Dec. 1943 — June 1946	12.3
June 1946 — Jan. 1948	3.9
Jan. 1948 — Nov. 1949	1.2
Nov. 1949 — April 1953	4.3
April 1953 — April 1954	0.2
April 1954 — May 1955	4.3
May 1955 — Dec. 1956	1.1
Dec. 1956 — Jan. 1958	0.9
Jan. 1958 — June 1959	4.1
June 1959 — June 1960	2.3
June 1960 — Jan. 1962	2.4
Jan. 1962 — Sept. 1962	0.3
Sept. 1962 — April 1966	4.5
April 1966 — Jan. 1967	0.3
Jan. 1967 — Jan. 1969	7.3
Jan. 1969 — June 1969	4.0
June 1969 — Dec. 1969	0.7

¹Sources: Basic data for June 1914 - December 1946: Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960*, (Princeton: Princeton University Press, 1963), Table A-1, Col. 7. Basic data for January 1947 - December 1969: Board of Governors of the Federal Reserve System.

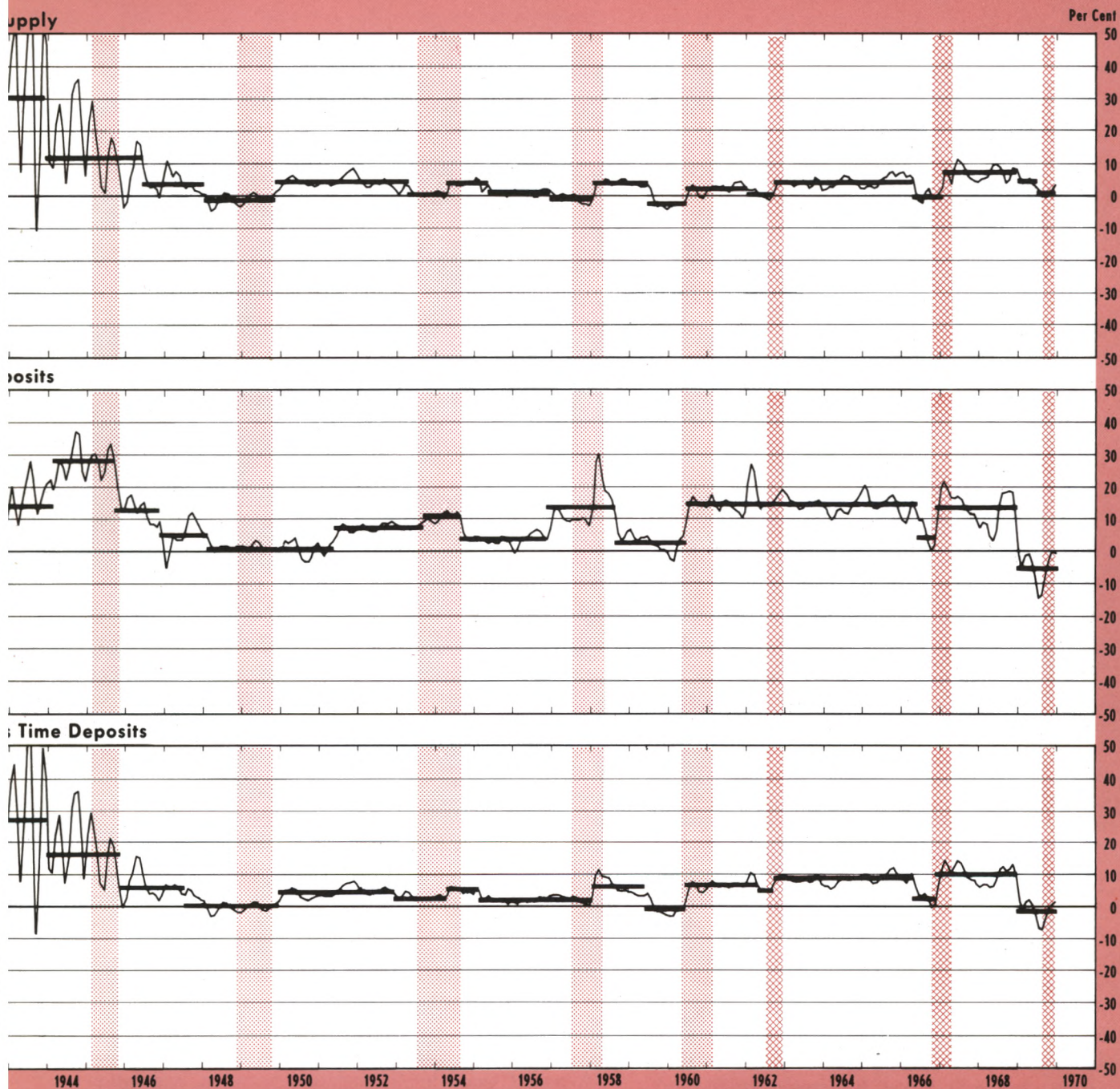
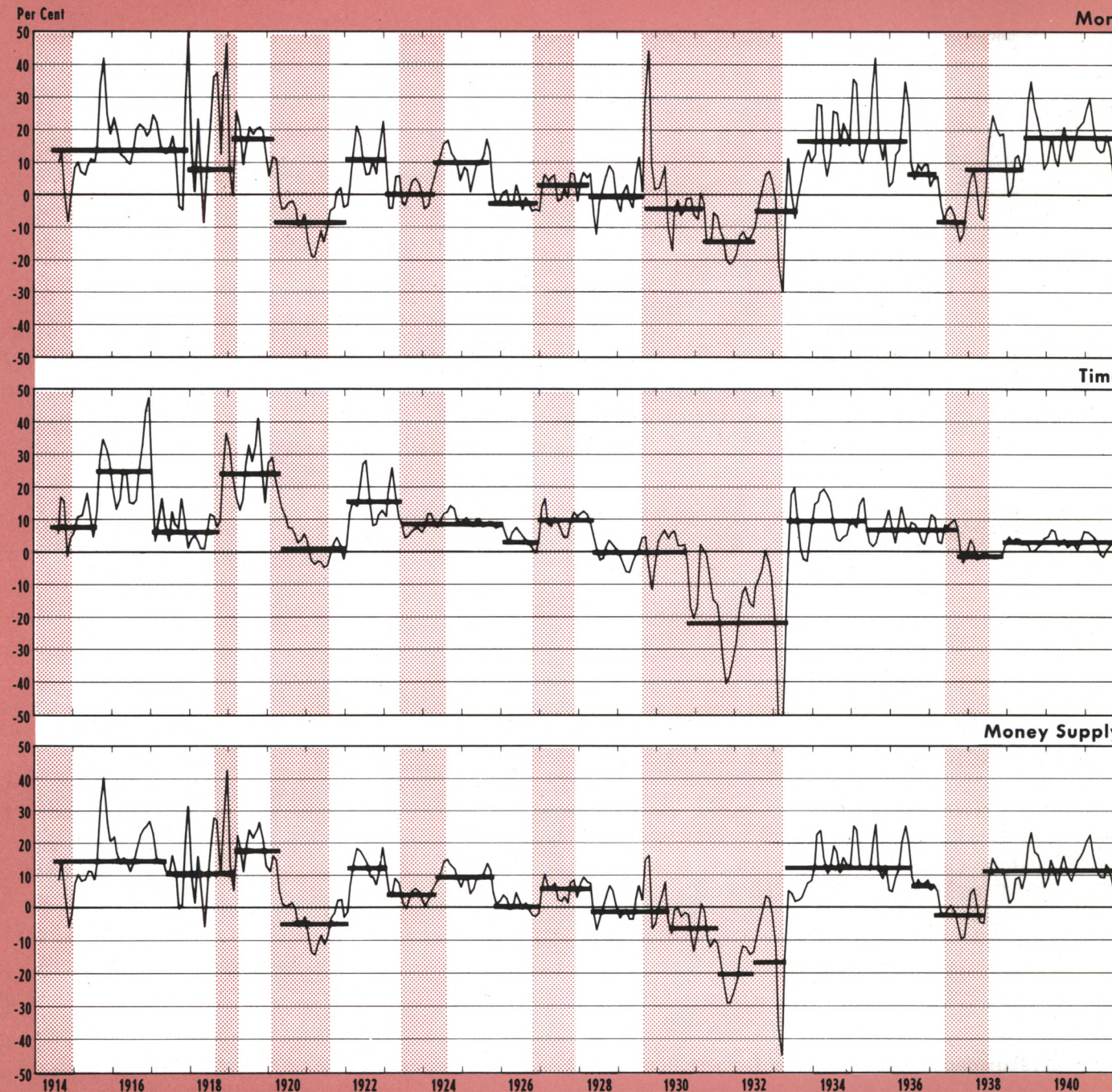
demand for them, have contributed to significant corresponding economic expansions and contractions.¹

The growth rates of both money and money plus time deposits have generally declined prior to peaks in business activity and have risen before troughs. As shown in the two-page chart, the average rates of growth of money and money plus time deposits declined prior to the 1967 hesitation in economic activ-

¹Similar conclusions have been reached using more sophisticated statistical methods. See Leonall Andersen and Jerry Jordan, "Monetary and Fiscal Actions: A Test of Their Relative Importance in Economic Stabilization", this *Review*, November 1968, pp. 11-24; and Michael Keran, "Monetary and Fiscal Influences on Economic Activity - The Historical Evidence," this *Review*, November 1969, pp. 5-24, and "Monetary and Fiscal . . . - The Foreign Experience," this *Review*, February 1970, pp. 16-28.

Money Supply and Time Deposits, 1914-1969

Compounded Annual Rates of Change



Three-month moving averages of compounded annual rates of change, weighted 1-2-1, computed from seasonally adjusted data.
 Bars indicate average rates for periods of no marked and sustained change in the rates of change.
 Shaded vertical areas, 1914 through 1961, indicate periods of business recessions; shaded vertical areas, 1962 through 1969, indicate recent periods of economic slowdown.
 Latest average plotted: December 1969 (which incorporates November, December and January data). The latest shaded area also terminates in December, although the slowdown may not have ended at that date.

Sources: 1914-46, Milton Friedman and Anna Schwartz, "A Monetary History of the United States, 1867-1960", (Princeton: Princeton University Press, 1963); 1947-69, Board of Governors of the Federal Reserve System.

Table III

TIME DEPOSITS¹
COMPOUNDED ANNUAL RATES OF CHANGE
(Seasonally Adjusted)

Periods of No Marked and Sustained Change in Rates of Change (represented by bars on chart)

	Annual Rates of Change
June 1914 — Dec. 1969	7.0%
June 1914 — Aug. 1915	7.8
Aug. 1915 — Jan. 1917	25.3
Jan. 1917 — Oct. 1918	6.4
Oct. 1918 — May 1920	24.3
May 1920 — Jan. 1922	1.3
Jan. 1922 — June 1923	15.5
June 1923 — Jan. 1926	8.8
Jan. 1926 — Dec. 1926	3.1
Dec. 1926 — May 1928	9.9
May 1928 — Oct. 1930	-0-
Oct. 1930 — May 1933	- 21.7
May 1933 — May 1935	9.7
May 1935 — Sept. 1937	6.9
Sept. 1937 — Nov. 1938	- 1.1
Nov. 1938 — Oct. 1941	3.0
Oct. 1941 — April 1942	- 7.4
April 1942 — Feb. 1944	14.1
Feb. 1944 — Sept. 1945	28.1
Sept. 1945 — Nov. 1946	12.7
Nov. 1946 — Feb. 1948	5.0
Feb. 1948 — May 1951	0.9
May 1951 — Sept. 1953	7.4
Sept. 1953 — Aug. 1954	10.8
Aug. 1954 — Nov. 1956	3.6
Nov. 1956 — Aug. 1958	13.4
Aug. 1958 — June 1960	2.8
June 1960 — May 1966	14.8
May 1966 — Nov. 1966	4.2
Nov. 1966 — Dec. 1968	13.7
Dec. 1968 — Dec. 1969	- 5.3

¹Sources: Basic data for June 1914 - December 1946: Friedman and Schwartz, *A Monetary History of the United States, 1867-1960*, (Princeton: Princeton University Press, 1963), Table A-1, Col. 3.
Basic data for January 1947 - December 1969: Board of Governors of the Federal Reserve System.

Table IV

MONEY SUPPLY PLUS TIME DEPOSITS¹
COMPOUNDED ANNUAL RATES OF CHANGE
(Seasonally Adjusted)

Periods of No Marked and Sustained Change in Rates of Change (represented by bars on chart)

	Annual Rates of Change
June 1914 — Dec. 1969	5.9%
June 1914 — May 1917	14.5
May 1917 — Feb. 1919	10.5
Feb. 1919 — April 1920	18.0
April 1920 — Jan. 1922	- 5.0
Jan. 1922 — Jan. 1923	12.4
Jan. 1923 — April 1924	4.1
April 1924 — Oct. 1925	9.7
Oct. 1925 — Dec. 1926	0.1
Dec. 1926 — April 1928	6.1
April 1928 — April 1930	- 1.0
April 1930 — July 1931	- 5.9
July 1931 — June 1932	- 20.0
June 1932 — April 1933	- 16.2
April 1933 — July 1936	12.5
July 1936 — Feb. 1937	6.7
Feb. 1937 — May 1938	- 2.4
May 1938 — June 1942	11.7
June 1942 — Dec. 1943	27.2
Dec. 1943 — Nov. 1945	16.7
Nov. 1945 — July 1947	5.8
July 1947 — Dec. 1949	0.4
Dec. 1949 — Dec. 1952	4.5
Dec. 1952 — April 1954	2.7
April 1954 — Feb. 1955	5.5
Feb. 1955 — Jan. 1958	1.9
Jan. 1958 — May 1959	6.4
May 1959 — June 1960	- 0.8
June 1960 — April 1962	6.9
April 1962 — Sept. 1962	4.6
Sept. 1962 — April 1966	8.7
April 1966 — Nov. 1966	2.3
Nov. 1966 — Dec. 1968	10.1
Dec. 1968 — Dec. 1969	- 1.5

¹Sources: Basic data for June 1914 - December 1946: Friedman and Schwartz, *A Monetary History of the United States, 1867-1960*, (Princeton: Princeton University Press, 1963), Table A-1, Col. 8.
Basic data for January 1947 - December 1969: Board of Governors of the Federal Reserve System.

ity. This slowdown in economic activity, although marked, was not severe enough to be classed as a recession by the National Bureau of Economic Research. The average rate of change for both money and money plus time deposits rose prior to the rapid increase in total spending, which began in the summer of 1967.

Movements in both money and money plus time deposits since 1914 have been broadly consistent with the hypothesis. However, when two variables are both consistent with a hypothesis, it is appropriate to ask which shows the most consistency in accord with that hypothesis. In this instance, the money stock, exclusive of time deposits, appears to be the better key variable. For example, beginning in November 1956, eight months before a business cycle peak, time deposits rose rapidly. In fact, in many instances since 1914, time deposits did not decline before a peak

in business activity nor rise before a trough. Therefore, the consistent behavior of money plus time deposits results primarily from the overpowering strength of the money variation, rather than the contribution of time deposits. It follows that money plus time deposits is a less sensitive variable than the money supply alone. Moreover, the change in the rate of growth of time deposits has been seriously affected in recent years by the relation between Regulation Q ceilings on interest rates banks are permitted to pay on time deposits and market interest rates.² As a result, the relation between time deposit growth rates and changes in total spending has been even weaker since 1964 than in earlier years.

²Charlotte Ruebling, "The Administration of Regulation Q," this *Review*, February 1970, pages 29-40.

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More Flexibility in Exchange Rates – And in Methods

by DR. WOLFGANG SCHMITZ, President of the Austrian National Bank
and Governor of the International Monetary Fund for Austria

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 co-ordination 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-

¹Annual 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)

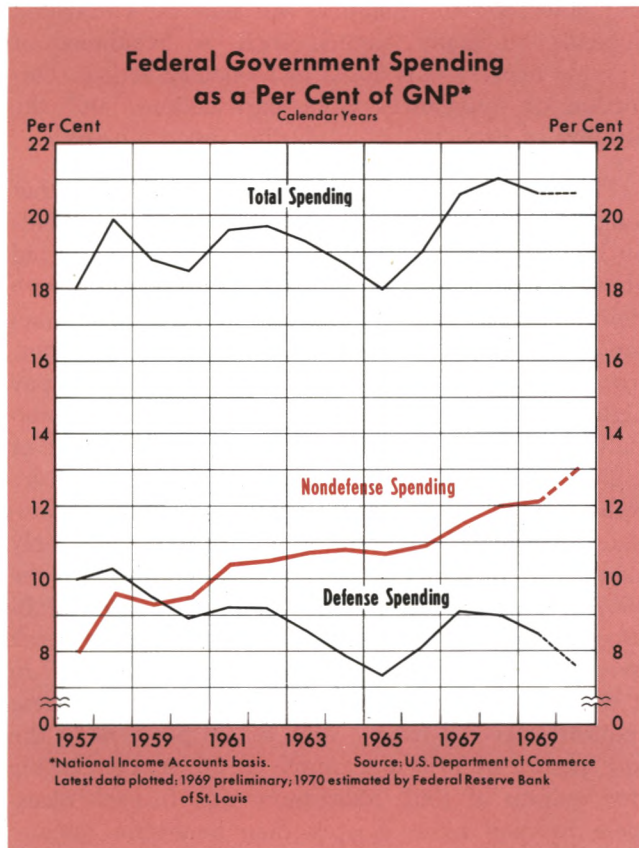
ten months ending May 1960. Fiscal actions remained restrictive for more than a year after the recession began. Money, however, began rising within two months after the recession commenced. The 1960-61 recession was probably the mildest of the three periods of adjustment considered here; total spending 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 moder-

ately 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

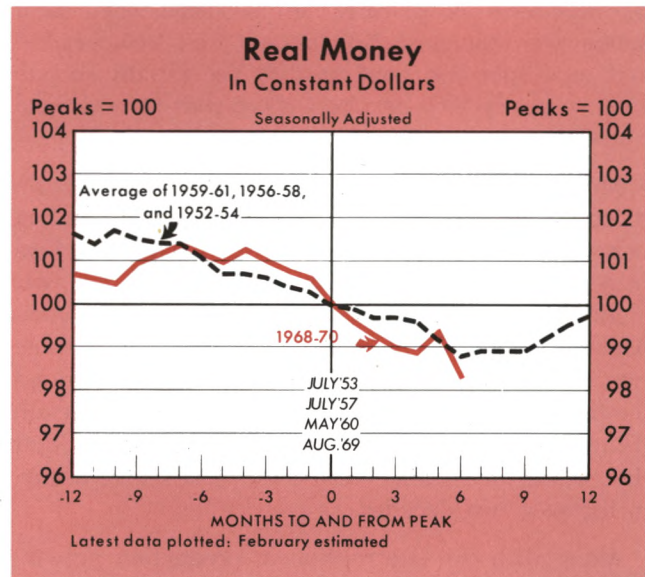


tax receipts tends to have a desirable stabilizing effect on total spending, and accordingly would not be reason for alteration of the high-employment budget plan.

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



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.

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.

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

²See 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.

