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The Crawling Peg—Its Inflationary Effects

by Professor Otto Veit, Frankfurt/Main *

Present-day monetary policies are moving on the rebound from those prevalent up to the end of the fifties. After the last war, western countries had made a big effort to replace the classical gold-standard, which had come out of World War II in an ailing state and had only briefly been restored to its apparent former glory between the wars, by a system of supra-national monetary cooperation. The intention was to retain some of the advantages of the gold standard but to leave the contracting parties with a wider scope for movement than under the rigid rules of a system based on gold only.

To Everybody His Own Rate of Inflation

But from about 1960, the tide of this movement has turned. Admittedly, international cooperation is still the intention but it is now desired that this joint endeavour aim at more independence for every single national government than could be enjoyed by them under any form of gold standard *ersatz* system. People generally take it for granted that worldwide creeping price inflation, to which each single country contributes in its own way, is inevitable, but individual countries do not wish to be interfered with, by the various rates prevailing outside their borders, in enjoying their own rates of inflation. The aim is a kind of international system which does not only acknowledge divergent rates of inflation but which saves every single country from enduring what would be the normal effect of its deviation from the average inflationary trend governing worldwide economic developments. Such a normal effect would be, if a given country's inflation makes swifter progress than that of the rest of the world, a deficit in its balance of payments, and consequently an inevitable bout of corrective deflation. Conversely, if the given country's currency should dwindle in value more slowly, its balance of payments would be in constant sur-

plus, which would have to be wiped out by corrective inflation. To sum up: what is desired is an international system which exempts everybody from these effects of uneven inflationary progress, and each single country claims the right to its own peculiar rate of inflation.

The two types of countries—those with a higher and those with a lower rate of inflation—try to free themselves from the compulsion to adapt their inflationary processes to the average rate of world inflation. Two kinds of methods to evade this pressure are used: those of physical exchange controls, and those of playing see-saw with the rates of exchange by devaluation, revaluation, introducing floating rates of exchange, and increasing the band width of permissible fluctuations. Public opinion and economic theory nowadays are both severely biased against the first form of evading adjustment, whilst the second one has come to be recommended and greatly admired. Undoubtedly, we may expect a rising number of experiments with the latter method, and therefore, it appears indispensable to open the discussion of it anew ¹.

Causes of Inflation

From the end of the last World War, individual countries have participated in inflationary developments in a twofold fashion: by the growth of demand for consumer goods at a rate that is faster than the increase in productivity; and by taking part in opening up additional sources of international liquidity.

Inflationary pressures set up by mounting demand for consumption nowadays attract the invariable commentary that the internal political set-up of all countries makes this inevitable. A continuous wage spiral, mounting welfare expenditure, spending for defence, and other forms of consumption—it is argued—must be considered as politically conditioned invariables to be accepted by any

* The present article consists of selected passages from an address given by Professor Veit to the "Frankfurter Gesellschaft für Handel, Industrie und Wissenschaft" (Frankfurt Society for Commerce, Industry, and Science) on November 26, 1969; see also the author's article in "Die Welt", of December 11, 1969, "Internationale Währungspolitik im Geleitzug" (International Monetary Policies Travelling in Convoy).

¹ The author has dealt with these problems in a number of contexts, cf. Otto Veit, "Grundriß der Währungspolitik" (Fundamentals of Monetary Policies), Frankfurt, 3rd edition, 1969, pp. 785 and seq.; "Währungspolitik als Kunst des Unmöglichen" (Monetary Policies as the Art of the Impossible), Frankfurt, 1968, pp. 121 et seq.

and every economic assessment of the situation. It is perfectly true that these political data have to be accepted, but the decisive question is where and when economic considerations have to place them in the order of priorities. Should they be adopted as basic fundamentals for any economic assessment, it will hardly be necessary to discuss them, for whatever is required by political conditions must be done and accepted. However, if it is desired to elucidate their influence, they must be introduced after the economic process in itself has been simulated in the form of a model. It is only in this way that these costs may be analysed as to their incidence upon the economy.

Then, and only then, will it be possible to discuss the question whether such costs can be supported by the balance of payments on international account. It will frequently be found that this is possible within the framework of worldwide average price inflation, but there will always be countries where exaggerated demand will push up the national inflation rate over and above the worldwide average. Credits of the International Monetary Fund and other forms of credit support may be able to postpone the day of reckoning for some time, but in the long run, it must be left to every individual country to fight its surplus inflation by its own unaided efforts, because credits must be redeemed at some time. When people maintain that this will be precluded by political circumstances, there are experiences which show that this is not strictly true. Such experiences have been made since 1968, not only by the Federal Republic of Germany, but also by the Netherlands, Italy and, most recently, possibly by the United Kingdom, too.

Bottlenecks of Liquidity in the United States

Admittedly, conditions in the United States are singularly difficult. There, it has become customary that, in spite of the country's gigantic productive power, the basic balance of international payments, composed of transactions of current accounts and of those of long-term capital movements, has remained in deficit for about a decade. This mounting deficit has been financed by floating dollar debts. It is true that the central banks of all countries like to hold US \$ as part of their international reserves but notwithstanding this, the US Treasury prefers to erect safety barriers against a big part of these dollar debts being called in for repayment in gold. A complete network of swap credit lines, of so-called Roosa Bonds, and of gentlemen's agreements with a number of countries which have pledged themselves to forego conversion into gold, have been set up as the outer defence

works of Fort Knox. In addition, there are potential liquidities arising from special drawing rights that have been awarded to the United States.

Yet the men in charge of US economic policy feel that this form of supporting and widening their liquidity is insufficient. After initial attempts at introducing limited exchange controls through cutting down capital exports, US leaders now work up an interest in manipulating the international rates of exchange, which would mask, for the superficial observer, the interdependence between dollar parity and the state of US payments on international account. It appears that there is in the centre of all discussion a method preferred by the Americans, that of an international agreement on shifting the rates of exchange by a number of small steps, which would no longer be tied to the strict rules of the International Monetary Fund. This method is known as that of the "crawling peg", meaning a gradual marking up or down of parity, as the case may be. The design would be that only the US \$ would be permitted not to "crawl", whilst all the other important trading nations would have to make their respective parities go up a few steps or down, as required. Their rates of exchange would crawl round the dollar, or slowly rotate. As nobody wants—and this for good reasons—to shift the gold price from the dollar parity which was fixed as long ago as 1934, the dollar would remain the fixed point of the whole system.

Difference Between the Crawling Peg...

It was no accident that the idea of introducing the crawling peg was particularly favoured by those who had to deal with the big German surplus on the balance of current transactions. At the present time, it is more likely that the intention is one of making revaluations of other currencies, as against the US \$, an established feature—being the de facto-equivalent of a devaluation of the dollar—than of devaluing the currencies of countries with a deficit, which would represent a de facto-revaluation of the US \$. It is, incidentally, an open question whether frequent attempts to devalue would not lead to an early loss of positive American interest in the crawling peg.

At any rate, it needs to be emphasised that such agreed and repeated changes in parity would be of a completely different nature, compared with entirely free and floating rates of exchange, which are recommended by many theoretical economists as an ideal way out of the present dilemma. Rates of exchange which are formed in complete independence would be influenced by every single payment made every day through

the foreign exchange markets, including, of course, capital movements. However, if the aim is that of flattening out the differences in rates of inflation as between different countries, the rates of exchange have to be worked out under a special formula, in whose composition the surplus or deficit balances on current payments account, i.e. for practical purposes the balances of current transactions, would play the decisive part. Any country which develops a lasting surplus on current transactions must be, under this formula, considered to be a force working for fundamental disequilibrium. Its rate of exchange would have to be varied, even though the foreign exchange market might not produce clear pointers along that way.

How to distinguish between a free rate of exchange and the envisaged method of instituting the crawling peg may be made clear from the example of the DM quotations during the brief period when the DM market rate of exchange was allegedly free between September 29 and October 24, 1969.

... And A Floating Rate of Exchange

The continuing surplus on current transactions of West Germany caused people to consider German DM revaluation to be inevitable. As was generally known, the Deutsche Bundesbank was in agreement with this. Since practically everybody was certain that revaluation would come, the market rate of exchange was not economically "free". Expectations more or less forced the value of the dollar to drop and that of the DM to rise. In the absence of such non-economic influences, it is more likely that, contrariwise, the DM's parity would have declined, as the overall German basic balance of payments had been mostly in deficit already from the beginning of 1969, because of the big outflow of capital.

As during the whole campaign in favour of German revaluation, both at home and abroad, the main argument had always been the state of the German balance of payments on current account (i.e. the balance on goods and services) and its mounting surpluses, the deduction is clear: what was meant was that the balance of current transactions is the main yardstick for the differences, from one country to another, between the rates of advance in productivity and in inflation. During the recession years of 1967 and 1968, German industry had rationalised to such good effect that Germany became the nation leading in economic progress. As long as the earnings spent on consumption do not grow faster than output, the German inflation rate will remain below that of other countries. It may therefore be argued that the pressure for DM revaluation was an attempt to force Germany to coordinate its foreign trade with the international inflationary trend, without at the same time forcing up prices in the German home market—which would be an open form of corrective inflation. Briefly and bluntly spoken, the aim was: to make Germany adjust to world inflation without going through a phase of adjustment inflation.

The Attraction of the Crawling Peg

Thus, German revaluation may be described, in a certain sense, as a first step towards adopting the crawling peg. The actual situation makes it clear, moreover, what are the present attractions of adopting such a system for the whole world. Countries whose rates of inflation differ from that of world inflation are in an embarrassing position. Those which suffer from a deficit will, in the long run, be forced to practise adjustment by deflation, whilst those in surplus must stage corrective inflation. For those in deficit, deflation is the only way to prevent an unstoppable leak



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of liquid funds, for those in surplus, rising prices in the home market appear inevitable. Only by manipulating the value of their currencies can they hope to evade the other forms of adjustment, thus getting again into step with the international rate of inflation, without at the same time having to worry about troubles on their home front. The United States, on the other hand, hopes to mitigate, with the help of the crawling peg, the difficulties into which it was plunged through the decision to maintain the gold parity of the dollar established in 1934.

But this alone does not exhaust the effects of such adjustments. We have to delve deeper. There is, for example, an important difference between the adjustment by devaluation in a deficit country, and correction by revaluation in a surplus country. Normally, the trading partners of a deficit country tolerate that country's devaluation as long as they do not fear an incisive competitive effect of this measure. On the other hand, trading partners of a surplus country usually press on this country the urgent desirability of a revaluation of its currency, so as to weaken its competitive power in exports and to enable themselves to sell more goods and services to the perpetual earner of surpluses. Seen from an international angle, the surplus earner is thus lifted up to a higher level of inflation. If such a country's share in world trade is big—Germany, after all, produces no less than 10 p.c. of all export and import trade of the world, and it exports even 20 p.c. of all the goods manufactured for international trade—revaluation of its currency also releases one of the brakes on the accelerating speed of world inflation.

Revaluation . . .

When important trading nations revalue their currencies, this invariably leads to a speed-up in existing international inflation. Conversely, devaluation of their currencies by important trading nations would strengthen any existing trend towards world deflation. Deflationary effects of this kind became widespread in the thirties, after the most important of all trading nations of the period, the United Kingdom, let the sterling rate of exchange gradually slide and thus forced all other countries to adapt their own currencies in due course, but Germany has now taken the first step in the reverse direction. Looked at from the outside, Germany has made a move through revaluation, which is equivalent to a sudden up-lift to its general price level—it has jumped on the bandwagon of worldwide inflation, and this may now continue.

To a certain extent, promotion of worldwide inflation was already the effect of the special tax on German exports and of tax remissions on imports through the Law to Safeguard Foreign Trade (*Absicherungsgesetz*), which has since been withdrawn. In quite a different manner, German revaluation was also anticipated by foreign countries, where a number of suppliers to the German market started, during the summer of 1969, to increase their prices by early surcharges. Taking in also the period from September 29 to October 24, when the German currency's parity was floating, it will be found that revaluation was not a single decision made and carried out at a fixed point in time, but a gradual process extended over a whole year. During that year, when people abroad confidently expected a step-up in the DM's value, foreign prices had drifted upwards. If it is stated that German revaluation has not been entirely a gift which Germany presented to its foreign trading partners, this has some element of truth in it, since Germany's partners are now even harder put to it to fight the forces of inflation on their own home ground.

. . . and International Inflation

This observation is frequently answered with the statement that this cannot be avoided in the fight against the international upward drift of prices invading the German market, for *tunica proprior palliost*, we must ask for understanding for this attitude. Yet it does not do away with grave concern lest the brake on prices in the German market, provided that it can be applied at all, is only the immediate effect of the measures taken, whilst we aid the other countries to plunge even more headlong into full inflation—which will certainly have its repercussions in forcing our price level up in due course. A few months ago, certain representatives of German savings organisations threw themselves into advocating revaluation with passion, which caused me to be ill at ease. It is likely that our exporting industries and the producers who have competitors abroad, will be able to overcome the effects of revaluation, in most of their branches. There will be cuts in their profits, and some wage increases may have to wait a little longer. All this may mean that industry will suffer less from the effects of revaluation than the mass of the population who demand stability of the cost of living, without any qualifications. This leads to the question: is then another, and another, and are many more doses of revaluation due? If this is to be the case, the effect will be a new spiral movement—exactly the spiralling effect which is the danger inherent in all crawling pegs.