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Intereconomics

*Suggested Citation:* Kebschull, Dietrich (1976) : A crawling peg system for raw materials, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 11, Iss. 9, pp. 245-247, <https://doi.org/10.1007/BF02929065>

This Version is available at:

<https://hdl.handle.net/10419/139405>

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# A Crawling Peg System for Raw Materials

by Dr Dietrich Kebschull, Hamburg \*

**Weighty objections have been raised against stabilization of commodity markets through agreements. The drawbacks of commodity agreements can, however, be largely overcome if the rigid theoretical notion of a price fixed strictly for a long period is abandoned.**

**T**he sharp price movements in the commodity markets make it easy to understand why the wish for stabilization of prices and earnings is an evergreen topic at international conferences. If prices slump unexpectedly, the countries to be hit most severely will be the developing countries in which the export trade is generally dominated by one or a few primary commodities. Among the major exporters of raw materials in the world there are as a matter of fact several industrialized countries — like the USA, the Soviet Union, Canada and South Africa — but these feel the effects of slumping prices far less because of the much greater diversification of their export structures. Commodity price stabilization is consequently primarily a problem of the developing countries which send their primary products largely to the industrialized states.

### **Vital Interest of the Poor Countries**

Contrary to a widely held opinion, the more advanced and foreign trade-intensive countries in the Third World would not be the only ones to benefit from a policy of stabilization in the raw materials sector. The poorer countries in particular could hope to profit from it because almost all their export earnings accrue from the sale of raw materials. In only three of the 25 countries of the group of least developed countries (LLDC) did raw material exports account for less than 90 p.c. of the total exports. In none of these countries they accounted for less than 70 p.c. Among the 42 "most severely affected countries" (MSAC) there were only four in which raw materials contributed less than 70 p.c. to the total exports<sup>1</sup>. As

the poor countries have the highest rates of indebtedness and are scarcely in the running for market-oriented foreign investments, the raw material policy is one of the few levers by means of which they can attain higher incomes and finance the investments needed for growth.

There are weighty objections against stabilization of commodity markets through agreements although wide price fluctuations for raw materials — especially explosive price rises as in 1972–74 — are not desirable from the point of view of either the importers or the consumers in the industrialized states. The major arguments advanced against such measures are the following:

☐ Commodity agreements cannot be a suitable instrument of development policy because they do not — as experience shows — bring about lasting stability. If prices rise sharply, suppliers often break away from the agreement. It happened in several instances that strong outsiders dashed the hope for price stabilization in the agreed price range.

☐ Prices are generally fixed so far above what would be a legitimate market price that the agreement is doomed from the outset.

☐ Price fixing vitiates the directive function of the market. Decisions on the kind and the level of production are left to an administration wanting flexibility. The consequence is general overproduction which involves factor misdirection and growth losses.

☐ Stockpiles (buffer stocks) and other forms of *dirigisme* involving output quotas for the individual producing countries become necessary so as to steady the prices.

☐ Commodity agreements are injurious to developing countries under long-term growth aspects

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<sup>1</sup> Cf. Dietrich Kebschull, Wilfried Künne, Karl Wolfgang Menck, Prüfung entwicklungspolitischer Ansätze im Rohstoffvorschlag der UNCTAD (Examination of development-policy approaches in the UNCTAD proposal for raw materials), Hamburg 1975, p. 38.

because the diversification of the production and export structure needed in the long term is prevented by the prices having been fixed too high. The market forces which would promote this structural change are deliberately inhibited.

□ The financing of the commodity agreements, including the stockpiles required for stabilization and the administration, involves an enormous capital outlay which the consumer countries are unable to take upon themselves. Insofar as development aid funds are employed for this purpose, there will be a shift of development policy in the direction of raw material stabilization which must arouse misgivings.

### **Hardened Fronts**

None of these arguments is really new but nevertheless no attempt has ever been made to move forward from this criticism to constructive concepts which do justice to the interests of the Third World without putting the basically liberal economic order of the western industrialized countries at risk. It is still a matter of being either for or against commodity agreements.

Instead of using international conferences as an opportunity to present meaningful new price stabilization models, the contestants are all too ready to seek refuge in seemingly simpler alternatives. These include in particular the — recently much discussed — schemes for the counterbalancing of fluctuations in export earnings and Kissinger's global raw material bank. A closer look shows however that such measures cannot work wonders. Commodity agreements therefore deserve to be given more consideration, for their drawbacks can be largely overcome if the rigid theoretical notion of a price fixed strictly for a long period is abandoned.

### **New Types of Agreement Needed**

The proposition that commodity agreements do not bring about lasting price stability is hardly refutable in the light of experience to date. But the main reason for this is not simply the attitude of the countries which participate in such agreements. In many cases the agreements lack stability largely because important producing and consuming countries fail to join. The sugar agreement for instance suffered from the outset from a handicap in that the EC and the USA stayed outside. In the case of tin the policy of stabilization through an official buffer stock was dashed by disposals from the US strategic reserve. Other agreements were affected in similar ways by the competition of strong outsiders. It is thus essential for the stability of commodity agreements that all producing countries concerned should be

brought in. The consuming countries must also accede to the agreements so as to be able to bring their influence to bear on the price policy.

This will not prevent individual suppliers from breaking away when prices rise sharply. But seeing that their conduct is in the first place a consequence of too low a price having been fixed originally, such occurrences refute the argument that the prices fixed under commodity agreements are as a general rule too high. The break-away shows on the contrary that the consumers have so far been perfectly able to safeguard their interests in regard to the determination of the prices.

### **Wide and Flexible Price Ranges**

This kind of supplier behaviour can be prevented if the agreement provides for a wide middle range over which the agreed price can move without intervention. The agreed price will undeniably in this case still sometimes be too high or too low if an agreement runs for five or ten years. The conclusion to be drawn from this is that prices cannot be fixed for more than medium-term periods at the most.

In addition there should be clauses permitting upward or downward price revisions when the supply-demand relationship appears to call for such corrections. Under the tin agreement this has been standard practice for years.

For this reason it is wrong to treat commodity agreements generally as tantamount to a vitiation of the market mechanism. They ought to be regarded rather as a means of preventing extreme price oscillations — as may occur owing to speculative movements or large crop fluctuations. They do not vitiate the market but guard it, to the advantage of producers and consumers, against extreme distortions. The interplay of supply and demand can still take place within a wide price range without intervention. Fundamental market changes are allowed for by price revisions and corresponding shifts of the price ranges. In the place of a rigid price corridor valid for the duration of the agreement there is thus a flexible range of prices. The wider a price range free of intervention is provided, the smaller will be the risk of instability due to speculation.

### **Promoting Diversification through Price Policy**

The competition with other products must be taken into consideration when the price and the lower intervention threshold are determined under a commodity agreement. Because of this factor the intervention threshold must not be fixed so high that substitution by synthetic materials or through recycling processes offers a cost advantage.

If commodity agreements provide for buffer stocks, certain maximum quantities or values can be agreed upon as indicators for price changes or price range shifts. The lower these are, the smaller will be the support costs under an agreement and the sooner will price corrections be effected. Agreements which do not provide for stocks to counterbalance price movements can specify time limits in lieu of indicator quantities or values. The prices would under such agreements have to be revised whenever the price falls below the intervention threshold or rises above the agreed ceiling for the period in question. Large control and administrative mechanisms are not required in this case. The market retains its directive function.

The charge that commodity agreements impede diversification cannot be brought against agreements of this kind, for all supplying countries must – even if major price falls may be ruled out – take the possibility of a price reduction into account. The structure of production will thus still have to be changed if the export earnings are to be raised in the long term. There is no need to agree on quotas because the producing countries can achieve the stabilization of prices only if they adjust their supplies to the demand in an appropriate manner.

#### **Lower Costs Possible**

Such costing of the establishment of buffer stocks as has been undertaken has been based on rigid arrangements. The capital outlays assumed necessary under various projections are accordingly of astronomical dimensions. UNCTAD assumed that \$ 12 bn. would be needed to establish, and \$ 1.8 bn a year to maintain, the envisaged raw material stockpiles. The European experts expect – on the strength of the experience with their agricultural market arrangements which resemble

commodity agreements – that twice or three times this sum will be needed. Without doubt it will hardly be possible to finance such stocks, especially if the money is to come entirely from development funds.

Agreements providing for flexible price ranges would however in practice involve more realistic figures. The choice of a wide price range and provision for adjustments in line with the mentioned indicators would greatly reduce the stockpile requirements. Besides, there is not much sense in operating and arguing with figures which relate to all the raw materials suggested by UNCTAD. It does not really seem reasonable to launch such an avalanche of agreements after a long period when there were only a few commodity agreements in operation. On this point at least the consumer countries seem to be more or less agreed that agreements should in view of the different conditions in the various commodity markets be concluded only on a case-by-case basis.

#### **Necessary Flanking Measures**

The proposal for flexible price ranges in commodity agreements is basically merely an extension of the tin agreement which has long been in existence. It may offer a practical mid-course solution between the stark demands of the developing countries and the rigid posture of the market-economy countries as it conforms to the interest of both sides in eliminating extreme fluctuations. It would be acceptable also to the Federal Republic.

The efficiency from the point of view of development policy of such an instrument could be increased by supplementary agreements on a credit system to counterbalance reduced earnings from exports and support for diversification in the raw materials producing countries by the means of trade policy and through private assistance.



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