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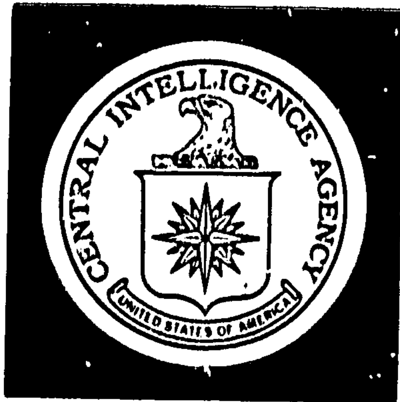

DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Brazil, Chile, And Colombia: Experience With "Crawling Peg" Exchange Rates

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1970

INTELLIGENCE MEMORANDUM

Brazil, Chile, And Colombia: Experience With "Crawling Peg" Exchange Rates

Introduction

Brazil, Chile, and Colombia have been confronted in recent decades with recurrent balance-of-payments strains caused partly by currency overvaluation. This overvaluation arose because they were slow to adjust exchange rates for rapid inflation. Inflation has continued in recent years, but in order to live better with it these countries have adopted "crawling peg" adjustments, which consist of small devaluations every few weeks.* This memorandum describes the new procedure and assesses its impact -- in part through comparisons with Argentina, Peru, and Uruguay, which retained more conventional adjustment procedures.

** Between adjustments, crawling peg rates (or smoothly moving parities) are held at fixed levels by government intervention in the exchange market. Crawling peg rates are distinct from "floating" rates, which are allowed to move more or less freely in response to supply and demand conditions with, at most, only tacit government support. Outside of South America, only South Korea has a crawling peg system. The fluctuating exchange parities currently in use in Canada and used temporarily in the Philippines and West Germany in recent years are properly classified as floating rates.*

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence.

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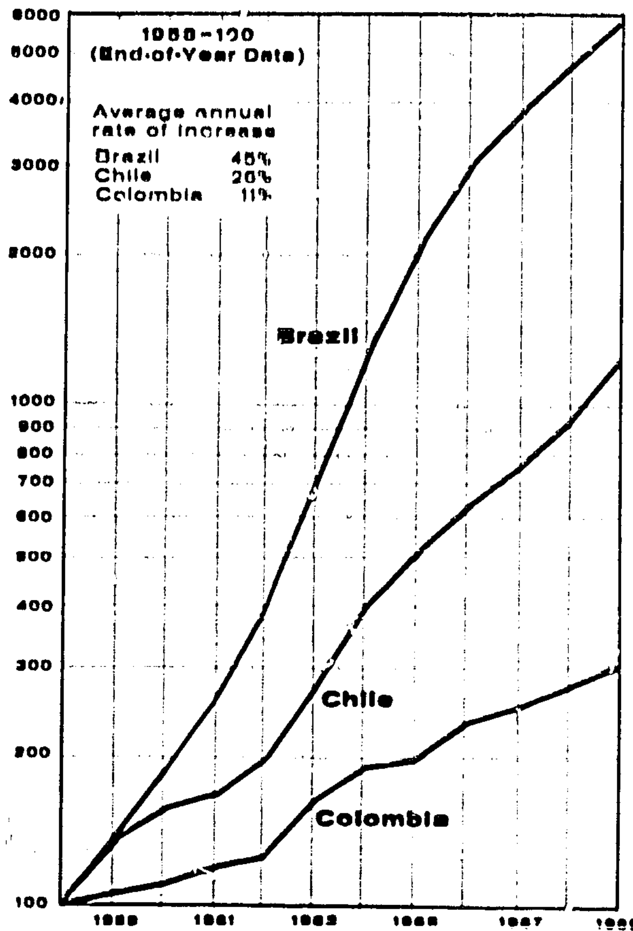
The Problem of Currency Overvaluation

1. Exchange rate adjustment has been important in most South American countries because of rapid (in some instances, raging) inflation. Brazil, Chile, and Colombia have experienced the problem in varying degrees, with average annual cost-of-living increases since 1958 of 45%, 26%, and 11%, respectively (see Figure 1). Their inflation primarily reflects large government deficits financed partly with central bank credit, which brought marked monetary expansion. In Brazil and Chile, it also reflects mounting wage-price spirals as businessmen and organized labor sought to maintain their real incomes. The three countries have repeatedly initiated financial stabilization programs to control inflation and have had some success in recent years. So far, however, political obstacles and social considerations have kept their price increases well above those of developed countries important to their trade.

Figure 1

COST-OF-LIVING INDEXES



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2. The countries' rapid inflation called for prompt, substantial currency devaluations, but they were delayed because of expected adverse political repercussions and the added inflationary impact.

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For example, from 1956 until it adopted the crawling peg in 1962, Chile did not adjust the exchange rate despite a 90% cost-of-living rise. During 1959-66, while the cost of living increased about 140%, Colombia made only four major adjustments, permitting its currency to be overvalued for extended periods. In the decade before adopting crawling pegs, Brazil devalued an average of once a year, but rampant inflation nevertheless caused substantial currency overvaluation between adjustments.

3. Currency overvaluation caused severe balance-of-payments strains by deforming trade balances and provoking capital flight. Reduced profitability of foreign sales (and inability to sell some goods) at established exchange rates restricted export expansion; at the same time, import demand was greatly stimulated by making some foreign products relatively cheap. As foreign payments strains mounted, growing prospects of a large devaluation or import and exchange controls usually prompted speculative flights of capital. Instead of devaluing frequently, the countries drew down reserves, imposed import and exchange controls, and (in some instances) subsidized major exports.

4. Currency overvaluation thus distorted resource allocation and slowed economic growth. Export diversification was discouraged (especially into manufacturing), leaving Brazil and Colombia dependent on coffee for 40%-60% of exports and Chile on copper for 65% of exports when they adopted crawling pegs. Actual or threatened exchange controls, particularly over profit and capital repatriation, at times deterred private foreign investment. Slackening exports and capital inflows and weakened foreign reserves limited import capacity and economic growth.

Introduction of Crawling Peg Adjustments

5. The three countries introduced crawling peg exchange rate adjustments over a six-year period. Chile initiated them in October 1962, when the Alessandri government's initially successful stabilization program was giving way to accelerating inflation and when trade and exchange controls imposed the preceding January were proving ineffective. In Colombia, the newly elected Lleras government adopted

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the crawling peg system in March 1967, along with trade and exchange controls and sweeping financial stabilization measures. Brazil's military regime introduced the new procedure in August 1968, when -- after four years' stabilization efforts -- further slowing of inflation seemed problematic.

6. At the time, the three countries were losing substantial foreign reserves because of trade deficits and (in Brazil and Chile) capital flight in anticipation of large devaluations. Brazil and Chile devalued moderately at the outset and then sought to maintain suitable exchange rates through crawling peg adjustments. Brazil devalued by 12% immediately, and Chile spread an initial 32% reduction over three months, devaluing by 18% the first month. Colombia, on the other hand, used trade and exchange controls to ease immediate payments difficulties and aimed at improving the exchange rate gradually, through crawling peg adjustments that would outweigh continuing inflation. Bimonthly adjustments made within six months devalued Colombia's currency by 12%. For Chile and Colombia, these initial devaluations were grossly inadequate, compensating for only 40%-50% of inflation since the preceding devaluation. For Brazil, however, the initial adjustment accounted fully for the interim price increase and gave the cruzeiro a reasonable value.

7. Under the crawling peg system, the three countries' central banks (which control nearly all foreign exchange) have fixed new buying and selling rates every few weeks.* The banks support these rates at exactly the level announced. The timing and extent of rate adjustments do not follow rigid patterns -- an apparently deliberate feature that the banks hope will minimize speculation. Changes in foreign reserves and domestic prices have been the general criteria for adjustments, but little

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* *The crawling peg procedure applies primarily to general exchange rates for trade, but the countries' other rates have been adjusted commensurately. When crawling pegs were adopted, Chile had rates for trade and capital transactions; Colombia, rates for general trade, capital (since abolished), and coffee; and Brazil, rates for coffee and all other transactions.*

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is known of how the banks determined their precise extent and timing. The International Monetary Fund (IMF) approved crawling pegs as part of standby credit agreements with the countries, but it apparently has not tried to enforce strict rules regarding adjustments.

8. Although crawling pegs generally promised to boost export earnings, Brazil and Colombia necessarily were concerned about stimulating coffee output through increased proceeds (in domestic currency) for growers. Since the countries were already fulfilling their export quotas under the International Coffee Agreement (ICA) and increased output would simply boost stocks, they limited the rise in producer profits by raising support prices less than devaluation raised coffee export proceeds. This step also helped to moderate inflation by limiting coffee growers' incomes and swelling government revenues, which include nearly all profits on coffee exports.

Impact of the Crawling Peg Procedure

Movement of Real Exchange Rates

9. Since adopting crawling peg adjustments, all three countries have held their real exchange rates* below earlier levels (see Figure 2). Chile has had both the most extended experience and the greatest success in maintaining the initial devaluation. By the end of 1963, Chile reduced its real exchange rate for general trade by 33%. In October 1963, however, following sharply rising world copper prices, it adopted a special rate for copper exports that was permitted to rise through 1964 to limit copper company profits, in terms of escudos. Chile also permitted the general rate to rise during 1964-65 but abolished the copper rate at the end of 1966 and by December 1969 had reduced the reunified rate almost to its earlier low.**

10. Both Brazil and Colombia have lost ground in holding down real exchange rates. By the second

** Defined as the nominal rates adjusted for inflation.*

*** Since August 1970, Chile has not made any crawling peg adjustments despite continuing rapid inflation. The Allende government, inaugurated in early November, has severely criticized the crawling peg system and indicated that it will be abandoned.*

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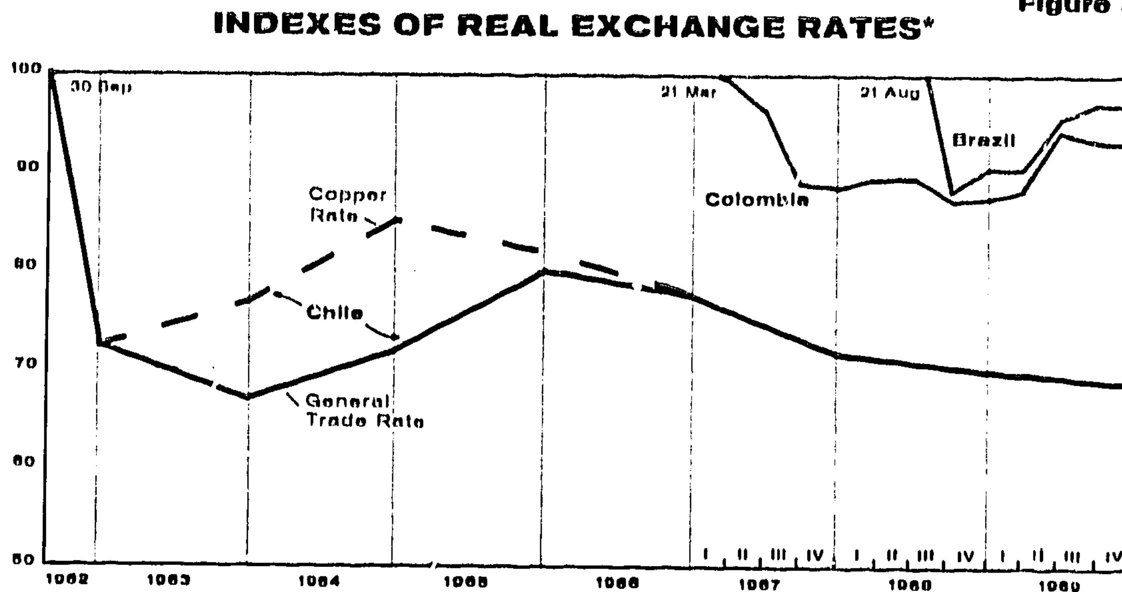
Figure 2

INDEXES OF REAL EXCHANGE RATES*



*Obtained by dividing indexes of the currencies' external value (expressed in US $) by indexes of their internal value (expressed as reciprocals of cost-of-living indexes). A declining index of real exchange rates indicates devaluation that more than offsets price increases – generally a favorable development for the balance of payments.

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half of 1969, Brazil's rate was only 2%-3% below the earlier level. Colombia made good progress for 2 years but suffered a partial setback in 1969. Crawling peg adjustments nevertheless gave both countries more favorable real exchange rates than under the old procedure, under which inflation commonly offset devaluation within six months.

11. The recent movements of real exchange rates in Brazil and Colombia do not differ greatly from those experienced in Argentina, Peru, and Uruguay under more conventional procedures. In 1967 the latter three countries sought to ease balance-of-payments strains by means of large devaluations and harsh anti-inflation programs. Nominally, Argentina devalued by 29% in March 1967, Peru by 31% in September 1967, and Uruguay by 50% in November 1967 and 20% in April 1968. The real devaluations of Argentina and Uruguay were considerably smaller, however, because the countries raised export taxes to capture much of the gain in exporters' profits. Peru accomplished somewhat the same result by advancing the payment schedule for corporate income

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taxes. The return of real exchange rates to the pre-devaluation level was slowed by the three countries' considerable progress in checking inflation and, in Argentina and Uruguay, by gradual cuts in export tax rates. By the end of 1969, Argentina's and Uruguay's real exchange rates (like Brazil's) were back near where they started, since nearly all of the initial improvement in their exchange rates had been offset by domestic price rises. Peru's real rate remained about 10% below its pre-devaluation level, however.

Effects on Trade and Capital Flows

12. After Brazil, Chile, and Colombia adopted crawling pegs, growth of export earnings accelerated, capital inflows rose, and speculative capital flight generally stopped. Crawling pegs contributed to these gains but played a large part only in Brazil and Colombia.

13. Brazil's export earnings from items other than coffee -- the expected beneficiaries of improved exchange rates -- rose from about $950 million (57% of exports) in 1967 to $1.4 billion (61% of exports) in 1969 (see Figure 3) and are doing well in 1970. The gain averaged 22% annually, compared with 6% during 1959-67, and was by far the largest two-year rise during the 1960s. It was paced by cotton, beef products, and cocoa, with manufactured goods remaining a very small share of sales. Apart from a reduced real exchange rate, export expansion was aided by favorable crop conditions, generally strong markets for coffee and other farm products, and increased government export promotion. Import growth moderated in 1969, contributing to the emergence of a small trade surplus. Brazil's receipts of short-term private capital accelerated further after crawling pegs were introduced. Growing strength in the balance of payments boosted Brazil's foreign reserves from $200 million to $600 million during 1969 and probably was a major factor in allowing the real exchange rate to rise.

14. In Colombia, exchange rate adjustments and trade promotion have contributed to substantially increased exports of items other than coffee and petroleum. These sales -- led by cotton, textiles,

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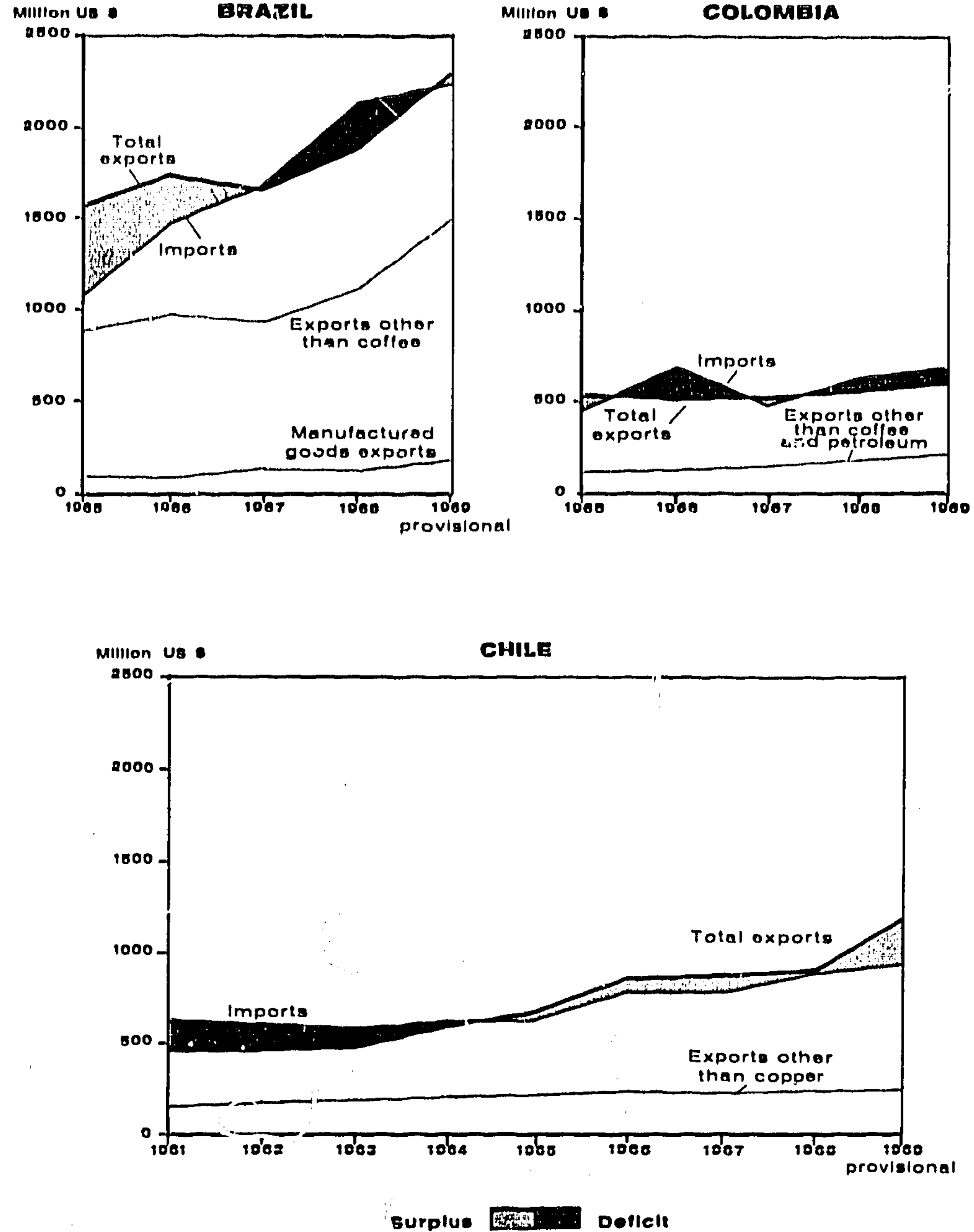
Figure 3



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and paper -- rose from $110 million (22% of exports) in 1966 to more than $205 million (34% of exports) in 1969. The average annual gain for these exports was 23%, compared with 13% during 1959-66. Total exports, however, have increased only moderately since 1966, because ICA quotas restricted the growth of coffee exports and declining reserves prevented expanded earnings from oil. Crawling peg adjustments have been insufficient to permit import restrictions to be removed, and export expansion has merely reduced the trade deficit somewhat from the substantial 1966 level. At the same time, the new system has strengthened business confidence and helped to attract more private capital, which -- with increased foreign aid -- has raised foreign reserves gradually.

15. Chile's initial devaluation and subsequent exchange rate adjustments were too small either to make non-traditional exports very profitable or to permit import controls to be abolished, despite soaring copper export revenues. Exports other than copper rose only from about $165 million in 1962 to about $235 million in 1969. Dramatically increased world prices, however, pushed copper exports from about $325 million in 1962 to about $950 million in 1969, when they made up 80% of the total. The crawling peg system, along with tight exchange controls, generally eliminated capital flight, although it revived in presidential election years. The marked improvement in foreign reserves since the mid-1960s, however, reflects mainly increased foreign aid, large US-financed copper investment, and continuing moderate trade surpluses generated by booming copper exports.

16. Argentina, Peru, and Uruguay, using conventional procedures, also have improved their payments positions since 1966, but export gains have been far less striking than in Brazil, Chile, and Colombia. There was little or no growth in Peruvian exports in either 1967 or 1969, and part of Argentine and Uruguayan gains represented a recovery to earlier levels. In Argentina, trade surpluses have been shrinking, and the speculative capital movements associated with its traditional devaluation practices have continued to be a problem. Its foreign reserves rose greatly after the 1967

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devaluation because of short-term capital inflows, increased a little in 1968, and then fell sharply in 1969 as capital flight recurred in anticipation of devaluation. Peru's trade balance improved sharply in 1968-69, largely, because imports dropped. Foreign reserves, however, registered little gain because of continuing capital flight and reduced inflows of foreign aid and long-term private capital, both attributable to expropriation of the US-owned International Petroleum Company properties and other government measures dampening the investment climate. Uruguay's foreign reserves rose moderately in 1967-69, following the devaluation, partly because substantial capital flight gave way to small capital inflows.

Crawling Pegs and Fiscal Irresponsibility

17. Some observers believe that a crawling peg system may encourage fiscal irresponsibility by reducing the adverse balance-of-payments effects of inflation. Without the discipline of fixed exchange rates, they argue, governments are freer to incur budget deficits and let private credit expand unrestrainedly. Experiences in South America, though brief in Brazil and Colombia, provide little support for this fear. Colombia's average inflation rate amounted to only 8% during 1967-69, compared with 11½% in 1959-66. Since adopting crawling pegs, Brazil has reduced its average inflation rate to less than 25%, compared with 50% in 1959-67. Although Chile's average inflation rate of 31% since 1962 exceeds that during 1959-62, it is an improvement over the preceding decade.

18. It is true, nevertheless, that Argentina, Peru, and Uruguay, using conventional adjustment procedures, made strikingly greater progress toward curbing inflation. Though their inflation rates rose or remained high under the initial impact of devaluations, they were cut decisively in the following years. Argentina did especially well, paring the rate from 32% annually in 1959-66 to only 7% in 1969. The inflation rate dropped in Peru from 9% annually in 1959-66 to 6% in 1969 and in Uruguay from 42% annually in 1959-67 to 14% in 1969. Progress in this area probably depends mainly on the government's character and strength rather than on specific devaluation practices.

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Conclusions

19. Chile, Colombia, and Brazil all benefited from adopting crawling peg exchange rate adjustments. But the benefits of the change (which occurred in 1962 in Chile, 1967 in Colombia, and 1968 in Brazil) varied widely. The procedure helped considerably in expanding exports other than coffee in Brazil and other than coffee and petroleum in Colombia. Chile's spectacular rise in export earnings, however, mainly reflected high copper prices. Growth of non-traditional exports in Chile and (to some extent) Colombia was handicapped by inadequate devaluation when crawling pegs were introduced. Speculative capital flight was avoided by Brazil and Colombia and was eliminated by Chile in most years. Crawling peg adjustments contributed to a dramatic rise in short-term private capital inflows in Brazil and increased inflows of long-term private funds in Colombia but were outweighed in Chile by rising copper prices and by other government measures affecting foreign investors.

20. Use of crawling pegs does not seem to have encouraged fiscal irresponsibility, as some observers have feared. Both Brazil and Colombia reduced their average annual inflation rates, compared with earlier years, and Chile's rate (though higher than the average for the preceding four years) remained below the average for the previous decade. Nevertheless, Argentina, Peru, and Uruguay -- which retained conventional exchange rate procedures -- made strikingly better progress in checking inflation than did countries using crawling pegs.

21. Although South America's brief experience with crawling pegs is encouraging, experience in Argentina, Peru, and Uruguay suggests that occasional major devaluations combined with periodic changes in export taxes and import tariffs can achieve some success. Speculative capital movements, however, remain a problem under this procedure. Although these often can be minimized by devaluing before it is generally considered necessary, such an approach is unusually troublesome politically and probably cannot be indefinitely successful. The more conventional approach probably works best where the government has the will and power to pursue a strong

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financial stabilization program. Crawling peg adjustments, on the other hand, seem an alternative worth consideration, most of all where, for political and social reasons, the inflation rate is likely to remain high.

22. The experience of the three countries using crawling pegs is not particularly relevant to developed countries. Developed countries are in a better position to control inflation and are under greater international pressure to do so rather than accommodate the exchange system to it. Adoption of crawling pegs has been discussed as one of several possible reforms of the international financial system. But the method usually proposed calls for automatic parity changes in accordance with an agreed set of rules, not occasional changes determined independently by national governments.

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