INFLATION AND CURRENCY RATES

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Floating exchange rates have now been the operative international exchange system for the past ten years or so. Their introduction at that time was greeted by widely varying public opinion.

The optimists hoped for a level of monetary autonomy, and for exchange rates which would follow the straight and narrow path of purchasing power. On the other hand the pessimists feared that floating would lead to serious problems and dislocations in international trade and capital movements.

Experience so far would seem to indicate that none of these extremist views is right. It is no more appropriate to speak of the grave effect of floating rates on world trade, than it is to speak of the complete autonomy of nations in regard to inflation, as was argued a decade ago.

Even if all the promises have not been fulfilled virtually nobody — except perhaps for the gold standard romanticists — sees any chance of a return to fixed parities in the near future. As long as economic policy priorities, for example with regard to fighting inflation, are not aligned among the important trading nations, and economic trends continue to vary, fixed exchange rates leave the door open for the transmission of inflation from one country to another. A current example is the fixed (within set limits) EMS system that links the Common Market countries' currencies together.

Switzerland was in the past a classic example of how a nation can import monetary erosion through fixed exchange rates. Persistent balance of payments surpluses (as funds flowed in chasing "rate/currency" stability) compelled the Swiss National Bank (the Central Bank) to intervene massively on the foreign exchange markets at the end of the sixties and the beginning of the seventies. Because as the foreign funds flowed in to constantly increase the money supply, demand grew uninterruptedly and this steadily fed the fires of inflation.

Of course the situation was further exacerbated through the existence of inflation even in the countries of origin of the incoming funds. The prices of goods there were rising, hence the value of their local currency's purchasing power was dropping. Hence the flight outwards of these funds. Simultaneously the prices of imports of internationally traded goods rose in tandem with the trends on the world market. Floating was considered as the way to block these channels (imported inflation and the old classic "demand pull" inflation).

Advocates of floating insist that exchange rates normally move parallel to trends of purchasing power. Over the long term this view has been proved right, but in the short term market quotations have by no means followed the "ideal" pattern, i.e. consistent with purchasing power.

In times of exchange rate dislocations there are limitations as to what extent autonomous national monetary policies can be adopted or followed. As revaluation of the currency is perceptibly taking place pressure on the central bank will mount to clear away the obstacles in the path of export-oriented companies. The required intervention on the foreign exchange market will exert an effect similar to that in a system of fixed exchange rates: by increasing the money supply it accelarates inflation.

In such a situation it is not surprising that previously planned money supply targets will be abandoned, or possibly modified. In the midst of a lot of chatter from the "experts" a rapid tunraround often takes place in the then current trend, and for the moment it might appear that the high value of the indigenous currency was unrealistic and that intervention was justified.

Sooner or later however the view often starts sinking in that the weakening of the currency is still accompanied by a continuing substantial price uptrend in the overseas markets, or in the sources of raw materials. And very quickly the relief at the improvement in export conditions gives way to worries about the rising rate of inflation. Only then does it become clear that the previous upvaluation had provided effective support for the stabilisation policy. The path from an overvalued currency to the vicious circle of devaluation and imported inflation suddenly appears quite short.

IMPORTED AND HOMEMADE INFLATION

Attempts at determining the shares of imported and "homemade" inflation in the overall rate of inflation of a country normally meet with considerable difficulties.

The approximate contribution of *homemade* inflation can be seen from the GNP deflator as this does not directly contain the prices of imports.

To determine the share of *imported* inflation the changes in the terms of trade can be used. The relationship between import and export prices is influenced by both the development of exchange rates as well as the prices of the exports and imports.

The GNP deflator and the change in the terms of trade together indicate the total rate of inflation, as measured by the price index, or deflator, of domestic demand.

There are however certain interplay effects between homemade and imported inflation the exact extent of which is difficult to assess.

In the following table, compiled by the Bank for International Settlements in Geneva (the central banks' own Central Bank!) from inflation statistics of five major industrialised nations, an inflation analysis is shown covering the period 1978-1981.

IMPORTED AND "HOMEMADE" INFLATION

	Switzerland[1]	West Germany	Italy	USA	Japan
Imported inflation[2]	Percent change in 4th quarter from previous year				
1978	–2.4	–0.6	–0.3	–0.3	–1.5
1979	0.5	1.2	1.4	1.5	4.2
1980	2.2	1.2	0.8	–0.1	1.8
1981[5]	0	1.3	3.0	–0.5	0.2
"Homemade" inflation[3]					
1978	3.3	3.5	13.7	8.2	4.0
1979	2.1	4.0	17.3	6.9	1.7
1980	3.1	5.1	19.8	9.8	4.3
1981	6.7	4.6	15.0	8.6	2.3
Total rate of inflation[4]					
1978	0.8	2.9	13.3	7.9	2.5
1979	2.6	5.2	18.9	8.5	5.9
1980	5.3	6.3	20.8	9.6	6.3
1981[5]	6.7	6.0	18.5	8.0	2.5

[1] Average annual figures [2] Change in the terms of trade [3] GNP deflator [4] Domestic demand deflator [5] Provisional figures
Sources BIS national statistics

The main conclusions to be drawn from the above table are:

(1) *Switzerland*, in comparison to the other countries, received the most support for its stabilisation policy from external sources between 1978 and 1981. Its "homemade" inflation of 3.3% in 1978 decreased by 2.4% to a total inflation rate of less than 1% in terms of the domestic demand deflator as a result of the improvement in the terms of trade.

(2) In *Japan* too the same factor brought the rate of overall inflation down by 1.5% in 1978. But then in 1979 Japan also had to deal with the highest rate of imported inflation of 4.2% and its total rate of inflation more than doubled to 5.9%.

(3) In 1980 and 1981 most *European countries* experienced substantial external stimuli to inflation, whereas the *United States* profited in its fight against rising costs from the strength of the dollar. Thanks to better terms of trade overall inflation was lower in the United States than the "homemade" rate.

EXCHANGE RATES

One of the main causes of the varying development of imported inflation is that it is sometimes exceeded by the fluctuations in exchange rates. On the foreign exchange market the purchasing power of the currency does not always correspond to the exchange rate at any given time. This has tangible consequences for the economy. The overvaluation of a currency has the effect of slowing down business and prices, whereas undervaluation speeds up domestic inflation.

The reason why exchange rates sometimes overshoot the mark is the lack of coordination in the economic policies among nations, particularly the monetary policies. If a country follows a more restrictive course than its neighbours, inflationary expectations decline. This in turn runs up the value of the country's currency and leads to a stronger inflow of capital. Through the cheaper prices of imported goods the country's fight against inflation receives external support.

However, there is a danger that the country's currency can become so strong that it jeopardises the competitive ability of the country's exporting companies, and places the producers for the domestic market at a disadvantage owing to the lower prices of imported goods. The intervention that becomes necessary under these circumstances thus limits monetary policy autonomy.

For the nations that pursue less restrictive economic policies this process develops in the opposite direction: the stabilisation policies of such nations suffer a setback due to the weakening of their currencies and they end up importing the inflation which the country whose currency is undergoing upvaluation "exports". Between 1980 and 1982 this interrelationship has proved a disciplinary instrument for Europe, whilst during the dollar's preceding phase of softness there was somewhat larger room for monetary manouvering.

When exchange rates move up or down in excess of purchasing power changes, the fight against inflation is temporarily impeded. However it should be remembered that, as hinted at the start of this paper, without floating it would probably not have been at all possible for the countries seeking stability to disengage themselves, at least to some extent, from the very worrying international trend towards inflation.

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