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The Exchange Rate and the Price Level

by Professor Manfred Willms, Kiel *

The US-Dollar has inflated the world. Its vehicle is the present international monetary system of pegged exchange rates. This system which was introduced to stimulate international trade and division of labour between the different countries became an important promoter of world wide inflation.

The main reason for world wide inflation is that a system of pegged exchange rates does not allow an independent monetary policy of the industrialized countries with the exception of the United States. For example, if a country like Germany wants to perform a restrictive monetary policy by slowing down the growth rate of its money stock the domestic level of interest rates will increase. Given unchanged interest rates in the Eurodollar market and in the financial markets of the United States this will induce an inflow of Dollars into Germany. Banks and other companies are borrowing abroad, where funds are relatively cheaper. The additional capital import leads to an increased supply of Dollars in the exchange markets. Thus the price of Dollars will fall.

The Inflow of Short-term International Capital

However, the price of Dollars cannot fall very much. According to the agreement with the International Monetary Fund the German Central Bank is obliged to stabilize the price at a margin of 0.75 p.c. below the pegged exchange rate. In such a situation the Central Bank has to buy Dollars in order to prevent a further decrease of the price of Dollars. However, every Dollar which is accumulated by the German Central Bank increases directly the stock of high powered money in the domestic economy. Through this interrelationship a restrictive monetary policy is at least weakened. If the situation continues for a longer time period the inflow of Dollars may increase more and more, so that monetary policy becomes completely ineffective: Instead of a reduction of the growth rates of money and credit their growth rates are accelerating.

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What can Central Banks do in order to dampen the inflow of short-term international capital? Are they completely helpless against the inflow of Dollars? The answer is no. Particularly the German Central Bank developed sophisticated instruments in order to control the inflow of foreign currency. The Bundesbank tried to neutralize the impact of international capital inflows on the money supply by stimulating capital exports and hindering capital imports. In periods of undesired capital inflows the Bundesbank offered commercial banks special forward rates. The intention of these interventions was to change the covered interest rate differential from a differential in favor of Germany to a differential in favor of the United States. Consequently, it became profitable for commercial banks to export Dollars instead of importing them. In addition, the Bundesbank introduced special required reserves for deposits of foreigners at commercial banks. Sometimes these reserve requirements were fixed at 100 p.c. for any increase in deposits. By these reserve requirements the impact of an increase of borrowing from abroad on the domestic money supply could be completely neutralized. Both measures, the forward exchange policy and special reserve requirements on foreign deposits were very effectively used by the Bundesbank for neutralizing the inflow of foreign currency through the banking system.

Multinational Companies

However, the actual instruments of the Bundesbank do not allow to control the capital inflow induced by non-bank economic units. Non-bank economic units are able to borrow abroad without any policy constraint. Mainly huge companies which are operating in both, domestic and international markets, are able to bypass a restrictive

domestic monetary policy. These companies have the necessary connections to borrow in any international financial market. In Germany, a relatively small number of these companies was able to reverse domestic monetary policy. Consequently, German central bankers consider the foreign borrowings of these companies as the main loophole in the money control process.

As inflation is a monetary phenomenon which has not very much to do with the monopolistic power of trade unions or enterprises the control of money is crucial in order to prevent price increases or to slow down the growth rates of increases in the price level. If price stabilisation is a goal of domestic economic policy the Central Bank has to neutralize the capital inflow from abroad by reducing the domestic sources of high powered money. For a limited time period a Central Bank is able to offset the inflow of foreign currency by increasing required reserves, the rediscount rate, and the rate on government securities. However, a continuing inflow of foreign currency requires a continuing increase of the absolute level of the policy parameters. It is quite obvious that there is a limit for the Central Bank and the Government to offset the impact of a continuous balance of payments surplus on the money supply. Although central banks and government officials do hardly believe in such a limit financial experts of international banks and companies do. Once they realize that the monetary authorities are not in a position to absorb much more Dollars, they know that a revaluation will come in the near future. Therefore, they try to make a profit out of the expected revaluation by selling Dollars at the official (overvalued) rate to the Bundesbank and buying them back after the revaluation at a lower price. The inflow of foreign currencies related to an expected upward adjustment of the price of the German Mark is called a speculative inflow. Once a speculative inflow starts all instruments of monetary policy are powerless. In such a situation the only adequate instrument is an adjustment of the exchange rate.

Revaluation or Inflation

This analysis shows two consequences of the present international monetary system:

- ☐ If a country does not alter its exchange rate it inflates its currency at the same rate as the United States.
- ☐ If a country revalues its currency from time to time it inflates its currency at a lower rate than the United States.

In the long-run there is no other alternative. Only in the short-run a country is able to have a lower

rate of inflation than the United States without an adjustment in the exchange rate. Only in the short-run monetary authorities can offset the effects of a disequilibrium in the balance of payments. However, monetary policy is never in a position to remove the causes of a disequilibrium in the balance of payments.

If a country pegs its exchange rate and if the exchange rate is not adjusted more frequently the fight against inflation becomes an illusion. This illusion is pretty expensive for a balance of payments surplus country. First of all the pegged exchange rate leads to a deterioration of the real terms of trade of the surplus country. The country exports more and more goods in order to import the same quantity of goods. In other words: Due to an undervaluation of the German Mark Germany has to export more and more Volkswagen and Mercedes cars in exchange for the same quantity of soybeans from the United States. As long as the prices of a surplus country like Germany are not adjusted to the international rate of inflation more and more of its goods are absorbed by other countries in exchange for fiat money. Thus, one effect of the present international monetary systems is a welfare loss in form of real goods by the surplus countries.

Other welfare losses are related to financial transactions. For example, an undervaluation of the German Mark sets incentives to citizens of other countries to buy real and financial assets in Germany. Although there is nothing wrong with this, the economic effects are similar to those mentioned before. German enterprises and financial assets are sold for a too low price. The same effects are given, if German banks and companies borrow abroad. If the Mark is undervalued they get their loans for a too low price.

Costs of the Present System

This analysis shows that the export industry, the big international companies, and the large banks are profiting from an international monetary system of pegged exchange rates. They are subsidized by the present system. This explains why the export industry is so much in favour of fixed exchange rates. It also explains why the German export industry is not only lobbying for a fast discontinuation of floating rates but also for a return to the exchange rate which existed until early May 1971. Such a demand is quite understandable. It is of course much more convenient for a company to exchange a Dollar of export revenue for DM 3.63 than for DM 3.43.

With respect to its attitude towards the present international monetary System the banking industry is in a dilemma. On one side it is in

favor of pegged exchange rates. Commercial banks have some foreign investments and like to return the profit at a high and guaranteed rate. On the other side they are interested in time and savings deposits which decline with an increasing rate of inflation. Therefore, with respect to these deposits they are interested in low rates of inflation and consequently in flexible exchange rates.

The present international monetary system results in a lot of misallocations of resources in the surplus countries. It leads to an overexpansion of the export industry and makes the adjustment for this industry, which is necessary with every revaluation, very difficult. In addition, it favors the expansion of big international companies and large banks.

The costs of this system are paid by the tax payer in the surplus countries. He does not only pay the direct losses of a revaluation but also the costs of the stabilization policy. Particularly in Germany domestic demand was always reduced when export demand led to inflationary pressure. In order to make further exports of goods and services possible without too much inflation a surtax on income was introduced in 1970. For the same reason the Coalition Government of Social Democrats and Liberals cut down considerably its planned investment program for structural reforms in education, environment, and health. This Government built up forced savings in Germany in order to support the balance of payments of the deficit countries, particularly of the United States.

The Position of the United States

Due to such policy decisions and the cooperation of Central Banks the United States is not forced to improve its balance of payments situation. As long as other countries are willing to deliver goods and sell their enterprises in exchange for paper in the form of Dollars there is no necessity to take any action. In addition, the US Treasury is correcting the situation to some extent. It offers US Government securities to the Central Banks. In that case the Central Banks get at least some interest income which they would not get for cash holdings of Dollars. At present they get $3\frac{1}{2}$ or 4 p.c. while the rate of inflation in the United States is close to 5 p.c. In the meantime foreign Central Banks hold so many US Government securities that they could perform an independent open market policy in the United States. However, international cooperation of Central Banks prevents this.

All of the mentioned effects of the present international monetary system are not very appealing

to the European countries particularly to Germany. What are these countries going to do in order to protect themselves against US inflation? In Germany, as a first action, reserve requirements on borrowings from abroad which exist already for banks, will be introduced also for non-bank enterprises. Another proposal is the control of foreign exchange. This implies a discontinuation of free convertibility of international currencies. The Federal Minister of Economics and Finance proposes fixed exchange rates between the European currencies and a joint floating against the Dollar.

Continuation of Inflation?

It is possible to realize price stabilization in Germany with any of these measures? The answer is no! Additional reserve requirements and exchange controls may enable the Bundesbank to neutralize the inflow of foreign currency on the domestic money supply for a longer time period than it is now the case. However, these measures cannot prevent inflationary pressures in the long run. It is a misunderstanding to believe that a disequilibrium in the balance of payments can be cured by monetary actions. Any effort in this direction implies tremendous welfare losses. These welfare losses are not only related to the current account but also to the capital account. Under welfare aspects it does not make much sense to differentiate between the two accounts. What matters is the total balance of payments. The Dollar from the current account is the same as the Dollar from the capital account, and every single Dollar presents a claim against the national product of the United States, independent of its source.

A floating of the pegged European currencies against the Dollar does not offer a better solution. The only difference will be that the less inflated German goods and assets are not any longer absorbed by the United States but by France, Italy and England and that the Bundesbank will accumulate Francs, Lires and Pounds Sterling instead of Dollars. These countries with their traditionally high rates of inflation will then be the winners. Pegged exchange rates within the EEC without a joint European Central Bank offer tremendous incentives for further inflation. If the European Currency Union starts with pegged exchange rates, as it is intended, it will be an inflationary Union.

Whatever the decision of the German Government will be once the present floating of the Mark is discontinued, more inflation will be ahead of us. There is only one chance for stable prices in Germany: The Government evaluates its own survival higher than unfeasible international agreements.