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Corporate Advice

What do the episodes of America's past and present inflation teach us?

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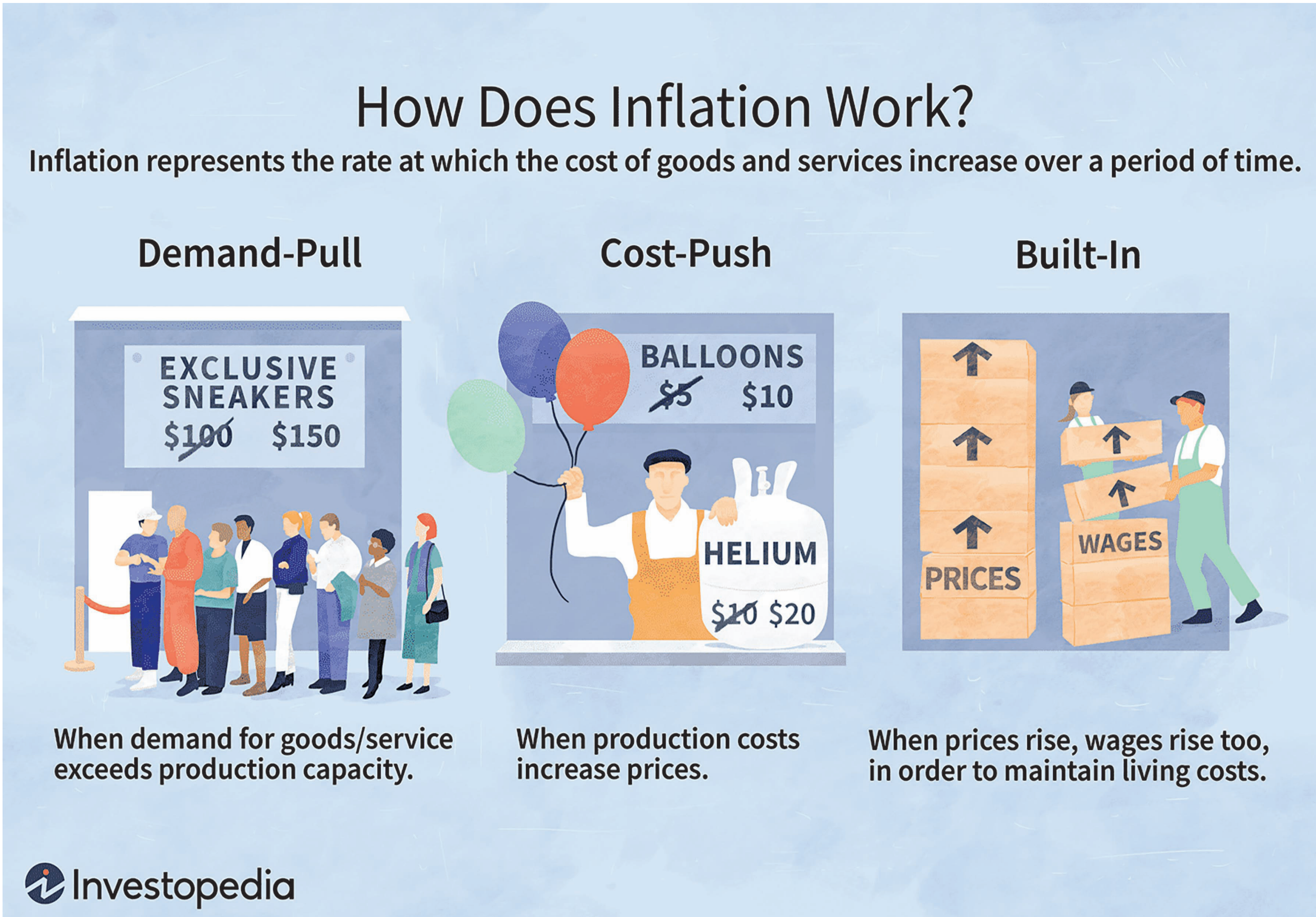

The central bank of the United States (US), the Federal Reserve (the Fed) has been on on a "war path to fight inflation" since May this year. The Fed began raising policy interest rate from near zero percent in April 2022 to 1% in May and with steady hikes each month by 50 to 75 basis points to 4% in November with some more hikes in the next next six months or so.The purpose is to contain rising aggregate demand. It was a delayed response, when signs inflationary signals were clear since May 2021.

The Fed ignored inflationary signs for more than a year and comforted the nation that they were due to transitory factors, which would vanish soon. Monetary tightening since May 2022 has yielded encouraging results. Inflation in October was less than the predicted rate of 8.0%. It was 7.7% in October decreasing from 8.2% in September, indicating a favourable declining trend.

The current global situation of high inflation is a resultant of easy money policy pursued by central banks led by the the Fed for long years with low interest rates for meeting the Great Recession (2008-2009), and then dilly-dallying in regard to normalization of monetary policy 2013-15 (known as taper tantrum years); which was followed by three years of return to some kind of recovery; and again with cheap money policy for meeting the adverse effects of the Covid-19 (2019-21) pandemic and the ongoing Russia-Ukraine conflict since February 2022.

Anti-inflationary measures

Aggressive contractionary policy measures of US since May 2022 by the Fed and synchronized interest rate increases by other advanced countries have wrecked the poor economies. Uncertainties have also arisen about likely recession due to fall in all components of aggregate demand, due to high borrowing costs for new investments and and fall in consumption loss of jobs and income.

Steady increases in the Fed interest rate led to reversal of capital outflows to the US from emerging market economies,(EMEs), because of the narrowing interest rate spread between US and the rest of the world.

Consequently, the US dollar has appreciated by more than 15% against world currencies. That depreciated poor countries' currencies much more, rendering their imports of capital and intermediate goods more expensive than before. Domestic inflation shot up as well. Rise in real exchange rate with adjustments for relative inflation to nominal exchange rate discouraged export competitiveness poor countries.

The foreign exchange reserves position deteriorated in all poor countries. The EMEs with comfortable reserves including India intervened in the exchange by selling dollars to arrest further fall in exchange rate. That led to reduction in the stock of their foreign reserves.

On the eve of the Group 20 Meeting of Presidents and Prime Minsters of the top 20 economies including EMEs, the US Treasury Secretary Janet Yellen told the press that US and advanced economies "should be cognizant of their policies having spillover effects on the rest of the world".

Every one knows that it is only a customary language used by diplomats from rich and powerful nations to pacify the aggrieved poor nations. Although it has no message of any assurance for the future, Dr. Yellen's words were much more gentle unlike what we heard in similar situations in the last century.

After the World War II, leaders from 44 nations met in Bretton Woods, New Hampshire, USA to develop a new international monetary system that came to be known as the Bretton Woods system. In 1958, the Bretton Woods system became operational with member countries setting up two international institutions, International Monetary Fund (IMF) and World Bank.

The IMF is to deal with financial stability; and solve balance of payment problems and the World Bank for providing assistance for post war reconstruction and development.

A fixed exchange rate system was agreed to, under which the reserve

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currency was dollar which could be converted to gold at a fixed exchange rate of $35 per ounce and the US is required to redeem its payment obligations also in gold aside from dollars. Thus, the US was committed to backing every dollar overseas with gold, while all other currencies were pegged to the dollar.

All the European nations and the rest of the world were importing capital goods from US such as transport vehicles, iron and steel and machinery for reconstruction and development. The US was rich with half the world's official gold reserves: 574 million.

A speedy postwar recovery by Germany and Japan, the US share of the world's economic output decreased from from 35% to 27%. In 1969, the US which has assumed the role of the Sheriff of the world mounted a war against Vietnam, which proved costly.

Enormous fiscal expenditure by US which has to be funded by a huge public debt, gave rise to emergence of an adverse balance of payments accompanied by steep inflation, fanned by growth in money supply.

All of them led to the overvaluation of dollar. The US wanted that way so its trade balance would improve. In a fixed exchange exchange rate regime, as currency was tied to gold, overvalued dollar kept the cost of imports lower otherwise. But, France and Germany wanted their exports to US should be settled in gold, not in dollar.

Treasury Secretary's Stunning Words

In 1971, the US economy was in crisis with high inflation at 6%, GDP near growth rate close to zero and high current account deficit. The US stock of gold went down to support the dollar, from 55% to 22%.

To fight inflation, on August 15, 1971. US Treasury Secretary John Connally imposed a 10% surcharge on all dutiable imports of US from Europe; a 10% reduction in foreign assistance to European countries in their defence preparedness against the then Soviet Union (remember it was the Cold War era); and temporarily closing the "gold window" (the dollar was no longer freely convertible) and domestic 90-day wage and price controls. In late 1971, in a meeting of Group of 10 rich nations, Connally stunned European nations' finance ministers with his infamous words: "The dollar is our currency, but it's your problem." .

The stock market cheered the "temporary" suspension of gold redemption and so did governments around the globe. It was also the beginning of the end of gold standard, which was official in December 1971. The rules of gold standard were stringent. Geoffrey Crowther, author of Money, described gold standard as"a jealous goddess: she needs exclusive devotion".

You have to deflate or inflate to come out of the cycles of capitalism. If gold stock is less to support the currency at the fixed exchange rate linked to gold, deflate; if gold reserves are more than needed at the fixed exchange rate to gold, you have to inflate. Always there are automatic checks on public spending under gold standard. By the end of 1971, the world officially got rid of the restrictive gold standard . The governments felt liberated, as the fiat paper money does not guarantee conversion into gold. You hold the paper money coin in trust.

The rest of the world knew then and now that there is no alternative to dollar, as a reserve currency. Every nation's currency is linked to US dollar. The only difference then and now is the value of world currencies are determined today at the market daily, round the clock, on the basis of supply and demand forces. Any good news, rise in petroleum crude output or any bad news such as 9/11 terrorist attack on the New York Trade Center Twin Towers affect the spot rate as well as the 180 days rate of dollar!

Holding more dollar reserves indicates strength of any nation, outside the USA. Dollars are earned through export of goods and services, including tourism, inward remittances and by attracting foreign private investment through good policies.

Can there be some more reserve currencies? Will one-country dominance in international finance be reduced Can G-20 with EMEs or any regional groups could emerge strong enough to "democratize the international financial system" in the midst of growing volume of trade and rising mobility of labour and capital in the New Millennium?

They are the issues, which now need greater attention. That is the lesson from the past and present inflation episodes.

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