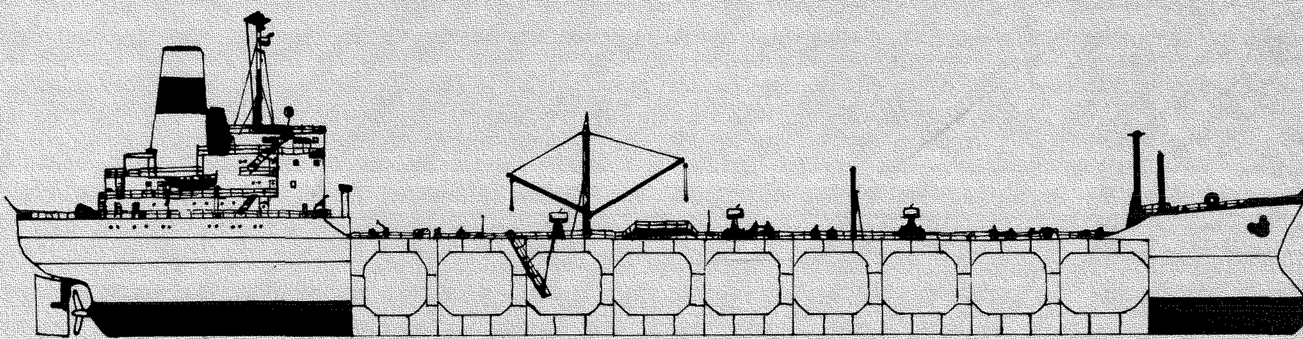
FEDERAL RESERVE BANK OF SAN FRANCISCO ECONOMIC REVIEW



RESPONSES TO INTERNATIONAL INFLATION

SUMMER 1980

Responses to International Inflation

The international economy, like the domestic economy, has learned to cope during the past decade or more with an environment of high risk and high inflation. Economists thus have increasingly focused their attention on the responses of various national economies to a difficult and fast-changing international environment. This issue of the *Economic Review* analyzes three such patterns of response. Can a regime of floating exchange rates provide more monetary independence than was possible under the fixed-rate regime characteristic of a less inflationary age? How does a nation (specifically, Japan) overcome a major burst of inflation, and at what cost to the nation's growth? Can the "financial deepening" process succeed in an era of repressed finance, where the authorities hold nominal interest rates rigid even in the face of general price inflation?

Adrian W. Throop addresses the first question, examining the claim that flexible exchange rates permit a greater independence of monetary policies by weakening linkages between national interest rates. Under the former Bretton Woods system of fixed exchange rates, foreign interest rates moved sympathetically with U.S. interest rates, and this interest-rate dependence made it difficult for foreign countries to pursue independent monetary policies. The system finally collapsed during the raging inflation of the early 1970's, mainly because nations were no longer willing to accept such a lack of monetary independence.

The world's financial authorities thus replaced Bretton Woods in 1973 with a flexible exchange-rate system. Theoretically, with perfectly "clean floating" — that is, without any central-bank intervention in the exchange market — foreign interest rates would be completely insulated from U.S. rates. But as Throop notes, central banks in practice have intervened in foreign-exchange markets about as frequently under the new system as under the old. Has "managed floating" then decoupled interest rates? "This depends not on the amount of intervention per se, but rather on the relative amount of intervention in response to interest-rate variations under the two different systems."

For four major countries — Germany, Switzerland, France and Belgium — Throop concludes that managed floating generally has severed short-run linkages between U.S. and foreign interest rates. This has occurred apparently because of reduced exchange-market intervention in response to interest-rate variations, rather than larger offsetting domestic monetary operations. Canada and the United Kingdom were atypical, however. In both countries, linkages to U.S. interest rates did not change significantly between the two exchange-rate regimes, because of unique Canadian and British policies.

Charles Pigott, in a second article, analyzes the causes of the rise and fall of Japanese inflation during the 1970's, and attempts to gauge the costs the nation incurred in its successful effort to reduce inflation. Consumer-price inflation decelerated from 25 percent in 1974 to only 3 percent in 1978, and the inflation rate remained below 5 percent in 1979. Japan's real-growth performance was somewhat less enviable, however. Between 1965 and 1972, Japan's real GNP grew at a 10 1/2-percent annual rate — but since 1975, real growth has averaged less than 6 percent.

Japan's experience confirms that the key to containing inflation is controlling money growth, in Pigott's view. "Without the 1971-72 acceleration in money growth, Japan's inflation in 1973 and 1974 would have been much lower than it actually was. Moreover, the relatively low inflation of the late 1970's was not the result of a fortuitous exchange-rate appreciation or government fiscal 'discipline', but rather of a consistent policy of containing money growth." But substantial increases in the domestic price level sometimes have resulted from other factors, such as the oil-price hike of 1974. In addition, Japan's monetary authorities have demonstrated that high budget deficits and foreign-exchange market interventions need not inevitably destroy monetary control.

Japan's experience is perhaps most interesting for what it reveals about the costs of reducing inflation, Pigott adds. His evidence suggests that Japan's attempts to reduce inflation through lower money growth substantially aggravated the 1974 recession. However, the evidence also suggests that the continuation of slow money growth was not primarily responsible for the sluggishness of the recovery. Instead, real growth may have lagged because the inflation and the ensuing recession undermined investor confidence.

Hang-Sheng Cheng, in a third paper, presents an overview of the financial-deepening process in eleven Pacific Basin countries during the inflationary period of the past two decades. For any nation, "financial deepening" represents an increase in the extent of financing of production and investment through specialized, organized markets. In developing countries, the process is identified with increases in the activity of financial intermediaries — such as commercial banks, savings institutions, and insurance companies — because of the general unimportance of capital markets. In developed economies, capital markets play a larger role than in developing economies, but financial intermediation still predominates in the savings-investment process.

To measure and compare financial deepening, Cheng provides a cross-section view of the degree of financial intermediation in each country in 1978, plus a comparison of the eleven countries' financial-growth process over the entire 1960-78 period. Financial-intermediation ratios in 1978 were significantly higher than average in Japan, Singapore and Taiwan, and significantly lower than average in Australia, New Zealand and the United States. In terms of growth over time, Malaysia, Singapore and Taiwan achieved nearly uninterrupted growth between 1960 and 1978. Most other countries also experienced at least some growth — except Australia and New Zealand, which sustained net declines in their degree of financial intermediation.

Cheng argues that the real deposit-interest rate played a critical role in setting the pace of each nation's financial growth. Positive real deposit rates maintained over a number of years invariably led to financial deepening, while negative real deposit rates (even over brief periods) could result in sharp financial disintermediation against an otherwise strongly upward trend. "Because of the importance of financial deepening for economic growth," he concludes, "economic policy should be aimed at reducing inflation, which by definition lowers the real deposit rate." He adds that where inflation cannot be brought down quickly, interest rates should be allowed to adjust with sufficient flexibility to permit a positive real rate of return to savings.