Impact Of Inflation On Exchange Rates In Switzerland

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Globalization, Inflation, and Exchange Rate Dynamics

The intensity with which globalization is taking place has greatly increased over the past years. This has been driven by several factors that favor international trading activities and investments (Engel et al., 2017). As the sole objective of many firms is to maximize profit, globalization has therefore been of great benefit to firms involved in the international trading system. However, governments have been able to facilitate such activities by removing bottlenecks that would deter international firms from carrying out trading activities in certain economies.

This has been achieved through the removal of trade barriers by governments. The trade barriers include tariffs and quotas, the removal of which has facilitated trading between various countries. However, there are several spillovers that affect the international market in relation to exchange rates (Thomas, 2015). The international trading system can thus affect a country's national income, and such cases should be examined by affected countries in order to combat unfavorable terms of trade. For instance, increasing income levels imply that there is an increase in consumer demand for goods and, thus, an increase in imports. Switzerland, having a strong connection with international markets, is exposed to such spillover effects (Jordan, 2010). Consequently, government interventions and national income greatly affect international trade. In attempting to correlate such factors, inflation and exchange rates also show some relationship.

When there is inflation in a country, it implies changes in the value and purchasing power of the currency in comparison with foreign currencies (Oliver, 2017). Depreciation or appreciation of the currency would determine whether exported goods become more or less expensive. In comparing imports and exports, imports may become higher than exports as the value of the country's commodities rises; therefore, the goods of the country become less competitive and demand goes down (Hwang, 2007). The increase in imports may lead to a devaluation of the currency and, thus, a reduction in its monetary value. The economy may therefore experience lower income from exports, which may serve as an important source of national income. Consequently, changes in inflation rates may lead to changes in exchange rates between trading countries (Thorbecke, 2017). Inflation thus has a great impact on the value of a currency and the rate of foreign exchange (Moore, 1995). It,

therefore, serves as one of the factors that influence a country's exchange rates. Significantly, inflation may have a negative rather than a positive impact on the exchange rate and the country's currency value (Friedman, 2017).

Governments and international companies may therefore use common exchange-rate arrangements to address disparities in inflation rates experienced by various countries. This is to ensure that a country's currency retains value in relation to other foreign currencies and to encourage bilateral and multilateral trading transactions (Thorbecke, 2017). The prices of commodities are affected by the adoption of exchange-rate arrangements, as countries facing inflation may experience changes in goods prices and currency values. However, an affected government may tend to increase interest rates in order to attract foreign investors, which would lead to increased demand for the country's currency (Sato, 2013). This presents a direct way in which inflation affects exchange rates.

However, inflation has an impact on many determinants of exchange rates and, thus, also affects government interventions (Parsva and Lean, 2017). For instance, the governments involved may adopt certain policies, such as fixed exchange rates, in order to combat the effects of inflation. As these effects are gradually reduced, the affected countries may become more stable in terms of their currencies. In the case of estimated inflation in Mexico, because of the slow adjustment of inflation, it could result in an elevated real exchange rate (Ciccarelli, 2010). There is a strong connection between interest rates and inflation. In a country where there is inflation, the government may tend to increase interest rates in order to stabilize purchasing power and attract foreign investors, hence increasing demand for the currency of that particular country. This could finally result in appreciation of the country's currency. When interest rates are low, the country's currency may lose value compared with other foreign currencies; hence, the government may intervene in such cases (Jon, 1980).

Terms of Trade and Flexible Exchange Rate Policy

The relationship between exchange rates and inflation is essential in determining the terms of trade between trading partners. These two related items, however, determine whether the terms of trade are favorable or unfavorable, as they may worsen or improve the terms of trade. To impose a change in exchange rates, the government may decide to adopt either a fixed exchange rate or a flexible exchange rate (Rodrik, 2008).

The terms of trade, as used in assessing the performance of a country's economic growth, are based on the value of imports and exports. Fixed exchange rates comply with the same conditions as Marshall's conditions in the terms of trade. This implies that when the terms of trade are favorable, there is an increase in the value of exports as compared with imports and vice versa (Marshall, 2005). However, this would not necessarily cause an increase in the current account when elasticities are high. On the contrary, when the terms of trade are low and there are more imported products than exports, the current account may deteriorate when elasticities remain high (Calvo and Reinhart, 2002). Fixed exchange rates are recommended for some young, growing economies because they

may not benefit from the advantages associated with flexible exchange rates due to a lack of reliable institutions. A fixed exchange rate serves as a means of stabilizing economies (Barro, 1985). Therefore, the central bank imposes a fixed rate that provides a basis for countries undergoing inflation to regain economic stability. Fixed exchange rates also help reduce unpredictable fluctuations in currency values, thereby providing a more reliable and predictable system. This eventually motivates exporters and investors and may help maintain inflation at lower levels. These rates also help maintain a stable current account (Thorbecke, 2017).

Flexible exchange rates are mainly adopted through government intervention in order to provide favorable terms of trade. When the terms of trade are low, firms may tend to lower the prices of their commodities, hence lowering export prices relative to import prices, and when the terms of trade are high, the currency may appreciate, which can result in higher export prices relative to imports (Miller, 1998). Flexible exchange rates, therefore, provide a country with a more independent monetary system.

Economic Benefits and Monetary Challenges of Currency Flexibility

However, there are several benefits associated with the adoption of a flexible exchange rate. The greatest benefit of a flexible exchange rate is that it allows a country to adopt an independent monetary policy instead of being constrained by a fixed exchange rate. In cases of global inflation, therefore, a country may be able to avoid a state of recession by applying flexible adjustments. According to Meade (1951), developing countries have been able to use flexible rates effectively, hence avoiding trade shocks. The argument is that changes in the external market may affect these countries less severely because they are able to adjust to the changes.

In assessing the economic production of a country, it is important to take notice of fluctuations in exchange rates (Thorbecke, 2017). The economy of Switzerland has changed greatly since 2007. Switzerland has a population of about 8.1 million and a Gross Domestic Product of 684.4 billion dollars, and it is ranked among the countries with high per-capita income. Switzerland specializes in the production of sophisticated products, maintains low inflation, and shows positive progress in wealth management, hence being ranked among countries with large GDPs (Thorbecke, 2017). Switzerland has widespread trade links all over the world. The goods and services exported account for about half of its gross domestic product. Exporters, having recognized market trends, have come up with innovative ideas and entered new markets.

Consequently, real and financial connections are both responsible for the dynamics of inflation in Switzerland and, therefore, for the monetary policy system (Eichenbaum et al., 2017). Changes in exchange rates that arise due to inflation can therefore be assessed by comparing real and nominal exchange rates. The appreciation value, which has been about 50% over past years (FT, 2016), is therefore calculated from the nominal rate. This shows that the appreciation value that does not

account for inflation has been above 20%. Switzerland has therefore experienced relatively low inflation compared with other foreign countries in Europe (Bhatnagar et al., 2017).

Swiss Inflation, Capital Mobility, and Policy Independence

However, the state enjoyed a long period of low inflation rates between 1994 and mid-2008, marked by a worldwide decline in inflation and efforts by central banks to ensure price stability. Amid short-lived inflation in imported goods, the country remained relatively stable, and the effects later became less persistent (Thomas, 2015). The financial crisis began after 2008, and the SNB therefore reduced interest rates to lower levels in order to improve monetary conditions. During this period, worldwide inflation also declined greatly, and Switzerland adopted measures to mitigate the global effects of inflation. During the crisis period, the SNB's room for maneuver was continuously narrowed, making it more difficult to conduct monetary policy through interest rates. This challenge was also influenced by monetary-policy conditions around the world.

However, small economies like Switzerland have often faced the challenge of balancing open capital accounts and monetary-policy independence while applying flexible exchange rates (Rey, 2015). Rey argued that the worldwide financial cycle often affects monetary policy in small open economies. Although global inflation has been quiescent over time, Switzerland has experienced very low positive rates of inflation. Kaufman and Egger (2014) noted that frequent price reductions increased after the inflation rate had fallen to zero. The pattern of price flexibility has, however, been found important in reducing inflation rates, thereby strengthening the Swiss franc.

In assessing the correlation between exchange rates and inflation, the two are found to have a weaker correlation because exchange rates do not solely influence inflation rates in Switzerland. Switzerland's stability has been attributed mainly to foreign investors who invested substantial initial capital in the country, thus making it stable (Aldcroft, 2017). Therefore, this has often led to demand for the Swiss franc despite increases in inflation in other countries. Switzerland's economy has thus attained stability by adopting flexible exchange rates (Ilzetzki et al., 2017).

The Swiss Franc, Export Competitiveness, and Economic Stability

The Swiss franc has also helped ensure economic balance even when there is global inflation. Consequently, during the period of economic crisis from 2003 to 2008, depreciation did not adversely affect the Swiss franc but rather boosted sales through exports, thereby causing a massive surplus relative to other economies. This led to great demand for the Swiss franc. This also encouraged foreign investment and, in doing so, led to an increase in Switzerland's monetary value. Increasing

demand for the Swiss franc has also facilitated innovation drives that have resulted in the competitiveness of various firms, hence making more surplus available (Thomas, 2015). This has ensured that even during appreciation, the Swiss franc is maintained at an equilibrium.

Based on the economic status of Switzerland, sophisticated exports help ensure maximum profit and stock returns. Based on Haussmann's (2002) methods, Switzerland has one of the most sophisticated export structures in the world, including in preceding years. Therefore, in terms of sophistication, watches and pharmaceutical products are ranked among the leading products. In 2014, 41% of exported products were found to be among the most sophisticated products. Therefore, no significant threat has been noted in examining exports and the returns obtained. The inelasticity of Swiss products has enabled firms in Switzerland to withstand some inflationary pressures. Although commodity prices may rise because of appreciation or inflation, effects from other countries do not necessarily affect the value of the Swiss franc in the same way.

Regression analysis also shows that a 10% appreciation of the Swiss nominal exchange rate leads to a decline in the price of exported capital goods by 4%. However, these changes do not necessarily affect the Swiss franc in the same way, especially for companies that produce high-technology products such as watches. They may also affect pharmaceutical companies differently in comparison with the euro. This shows that the Swiss franc can still maintain a stable equilibrium despite inflation. The chart below shows the nominal and effective exchange rates of Switzerland in comparison with those of its trading partners (Engel et al., 2017).

Exchange Rates and the Distinctive Inflation Experience of Switzerland

In conclusion, although exchange rates affect inflation, their effects do not apply in the same way to Switzerland as they do elsewhere. However, exchange rates are of great importance to the economy of Switzerland in dealing with these products (Bhatnagar et al., 2017). In the past, inflation rates in Switzerland have been reported as low, as opposed to constantly changing exchange rates. In an attempt to curb inflation, firms in various economies should be able to adjust according to the circumstances. Switzerland, however, has proven flexible by adjusting quickly on several occasions, as seen in past years.

Production of inelastic products has also contributed to the success of Switzerland. This is due to the price inelasticity of the products produced. In combination with the innovations that are currently taking place, this ensures that firms involved in production in Switzerland remain competitive. The innovations also help ensure the availability of surplus goods that are ready for export.

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