

Impact Of Inflation On Exchange Rates In Switzerland

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Globalization, Inflation, and Exchange Rate Dynamics

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

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

When there is inflation in a country, it implies that there is a rise in the currency value as the purchasing power goes higher in comparison to foreign currencies (Oliver, 2017). Depreciation or appreciation of the commodities to be exported would determine whether the price of goods would be expensive or less expensive. In comparing imports and exports, the imports are thus higher than the exports as the value of the country's commodities go higher, therefore, the goods of the country become less competitive and the demand goes down (Hwang, 2007). The increase of the imports leads to a devaluation of the currency and, thus reduction of the monetary value. The economy would thus be driven into a state of low income from exports, which may serve greatly the source of income. Consequently, changes in the inflation rates would lead to changes in the exchange rates between the trading countries (Thorbecke, 2017). Inflation, thus, has a great impact on the value of the 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, it has a negative impact rather than a positive result on the exchange rate and the country's currency value (Friedman, 2017).

The government and the international companies, therefore, would impose a common exchange rate to combat the disparities in the inflation rates experienced by the various countries. This is to ensure that a country's currency is of value in relation to other foreign currencies to encourage bilateral and multilateral trading transactions (Thorbecke, 2017). The prices of commodities are thus affected by the adoption of the common exchange rates as the countries facing inflation would have a depreciating price of goods and hence devaluation of the currency. However, the affected government may tend to increase interest rates in order to attract foreign investors, which would lead to the demand for the country's currency (Sato, 2013). This presents a direct way in which inflation affects the exchange rates.

However, inflation has an impact on every determinant of the exchange rates, and thus, it 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 the effects are slowly regained, the affected countries become more stable in terms of their currency. In the estimated inflation in Mexico, because of the slow adjustment nature of inflation, it would result in an elevated real exchange rate (Circarelli, 2010). There is a strong connection between interest rates and inflation. In a country where there is inflation, the government may tend to increase the interest rates in order to stabilize the purchasing power and attract foreign investors, hence increasing the demand for the currency of that particular country. This would finally result in the appreciation of the country's currency. When the interest rates are low, the country's currency may lose value as compared to the other foreign currencies; hence, the government may intervene in such cases (Jon, 1980).

Terms of Trade and Flexible Exchange Rate Policy

The relation between the exchange rates and inflation is essential in determining the terms of trade between the trading partners. These two related items, however, determine whether the terms of trade are favorable or not, as they may worsen or make better the terms of trade. To impose a change in the exchange rates, the government may decide to adopt either a fixed exchange rate or a flexible exchange rate (Rodrick, 2008).

The terms of trade, as used in assessing the performance of the economic growth of a country, are based on the value of imports and exports. The fixed exchange rates comply with the same conditions as the Marshall's conditions in the terms of trade. This implies that when the terms of trade are favorable, then there is an increase in the value of exports as compared to imports and vice versa (Marshall, 2005). However, this would not cause an increase in the current account when the elasticities are high. On the contrary, when there are low terms of trade (there are more imported products than exports), the current account when the elasticities are maintained high (Calvo and Reinhart, 2002). The fixed exchanges are recommended for young, growing economies as they may not benefit from the benefits accrued by the flexible exchange rates due to a lack of reliable governments. The fixed exchange rate serves as a means of stabilizing the economies (Barro, 1985).

Therefore, the central bank imposes a fixed rate that provides a ground for the countries undergoing inflation to regain their economic value. The fixed exchange rates also help to reduce unpredictable fluctuations in the currency, thereby providing a reliable and more predictable system. This eventually motivates exporters and investors as it even maintains the inflations 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 a favorable term of trade. When the terms of trade are low, the firms will tend to lower the price of their commodities, hence lowering the prices of exports than imports, and when the terms of trade are high, the government will apply an appreciation in the price of the exports, which results in increased prices of exports than the imports (Miller, 1998). The flexible exchange rates, therefore, provide a country with an independent monetary system.

Economic Benefits and Monetary Challenges of Currency Flexibility

However, there are several benefits that are accrued upon the adoption of a flexible exchange rate. The greatest benefit of the flexible exchange rate is that it allows a country to adopt an independent monetary policy instead of being constrained by fixed exchange rates. In cases of global inflation, therefore, the country will be able to avoid a state of recession by applying flexible changes. (Meande, 1951), the developing countries have been able to use the flexible rates effectively, hence avoiding trade shock. They argue that the deliberate changes in the external market do not affect these countries since they are able to adjust to the changes.

In accessing the economic production of a country, it is expedient to take notice of the fluctuations in the exchange rates (Thorbecke, 2017). the economy of Swiss has greatly changed since 2007. Switzerland has a population of about 8.1 million and a Gross Domestic Product of 684.4 billion dollars per capita and is ranked among the countries with high per capita income. Switzerland majors in the production of sophisticated products, maintains low inflation and shows positive progress in wealth management, hence being ranked the 10th country with the largest GDP (Thorbecke, 2017). Switzerland has a widespread trade link all over the world. The goods and services exported account for about half its gross domestic product. The exporters, having known the 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, the monetary poly system (Eichenbaum et al., 2017). The changes in exchange rates that arise due to inflation can, therefore, be obtained by deducting the real exchange rate from the nominal exchange rate. The appreciation value which has been by 50% over the past years (FT, 2016), is therefore calculated from the nominal one. This shows that the appreciation value that does not account for inflation has been above 20%. This has seen Switzerland undergoing a tranquil inflation as compared to other foreign countries in Europe (Bhatnagar et al., 2017).

Swiss Inflation, Capital Mobility, and Policy Independence

However, the state has enjoyed a long period of low inflation rates between 1994 to mid-2008, marked by a worldwide decline in inflation with little success by the central banks in ensuring price stability. Amid the short-lived imported goods inflation, the country remained favourably volatile but later was less persistent (Thomas, 2015). The financial crisis began after 2008, and the SNB, therefore, reduced the interest rates to lower levels in order to improve the monetary conditions. However this period, worldwide inflation has greatly reduced, and Switzerland adopted measures to mitigate the global effects of inflation. During the crisis period, the SNB domain has been narrowed continuously for gearing monetary policies through the interest rates. This was achieved through monetary policy around the world.

However, small economies like Switzerland have often been faced with the challenge of monetary policy between the open capital accounts and the independence on the other side amid the application of flexible exchange rates (Rey, 2015). Rey argued that the worldwide financial cycle often affects the monetary policy in small open economies. Although global inflation has been quiescent over time, there have been very low positive rates of inflation in Switzerland. Kaufman and Egger (2014) noted that frequent price reductions increased after the inflation rate had gone down to zero. The pattern of price flexibility has, however, been found crucial in the reduction of the inflation rates, thereby strengthening the Swiss franc.

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

The Swiss Franc, Export Competitiveness, and Economic Stability

The Swiss franc has also ensured the achievement of economic balance even when there is global inflation. Consequently, during the period of economic crisis from 2003 to 2008, the depreciation did not affect the Swiss franc but rather boosted sales (exports), thereby causing a massive surplus to other economies. This led to great demand for the Swiss franc. This also encouraged foreign investments and, by so, led to an increase in the monetary value of Switzerland. Increasing demand for the Swiss franc, however, has facilitated innovation drives that have resulted in the competitiveness of the various firms, hence availing more surplus (Thomas, 2015). This has ensured

that even in appreciation, the Swiss franc is maintained at an equilibrium.

Based on the economic status of Switzerland, the sophisticated exports which ensure maximum profit and stock return. Based on the (Hausmann 2002) methods, Switzerland has the best export structure in the world, even in the preceding years. Therefore, in terms of sophistication, watches and pharmaceutical products are ranked to be the first and third products. In 2014, 41% of the exported products were found to be among the most sophisticated products. Therefore no record of threat has been noted in examining the exports and the returns obtained. The inelasticity of the products of Swiss has enabled the firms in Switzerland to rule out inflation. Although the prices of commodities may go high due to appreciation for inflation, effects from other countries do not affect the value of the Swiss franc.

Regression analysis also shows that appreciation by 10% of the Swiss nominal exchange rate leads to a decline in the price of the capital goods exported by 4%. However, these do not affect the Swiss franc, especially the companies that produce high-technology products such as watches. It does not even affect the pharmaceutical companies in comparison to 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 rate of Switzerland in comparison with trading partners (Engel et al., 2017).

Exchange Rates and the Distinctive Inflation Experience of Switzerland

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

Production of inelastic products has also contributed to the success of Switzerland. These are due to the price inelasticity of the products produced. In collaboration with the innovations that are currently going on, it ensures that the firms that are involved in production in Switzerland remain to be competitive. The innovations also help to ensure the availability of surplus goods that are ready for export.

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