Two episodes of US inflation and responses: Are there any lessons?

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The central bank of the United States (US), the Federal Reserve (the Fed) has been on a "war path to fight inflation" since May this year. The Fed began resorting to steady increases in its policy interest rate from near zero percent in April 2022, first to 1% in May and ultimately to 4% in November. The purpose is to contain rising aggregate demand. It was a delayed response, when inflationary signals were clear in May 2021.

The Fed ignored inflationary signs for more than a year, comforting the nation that they were transient and would vanish soon. The Fed told the nation and the world that the factors responsible for the signs were only transient as they were transitory. After inflicting enormous pain for six months on the rest of the world, including poor developing countries and emerging market economies (EMEs), there are some encouraging signs of falling inflation in the world's richest nation since November 10. The latest data showed the US monthly inflation for October 2022 was less than the predicted rate of 8.0%. Inflation was 7.7% in October, falling from 8.2% in September, confirming the eagerly awaited declining trend since the tightening began in May 2022.

The current global situation of high inflation is a resultant of easy money policy pursued by central banks led by the Fed for long years with low interest rates for meeting the Great Recession (2008-2009) and then dilly-dallying in regard to normalisation of monetary policy during taper tantrum years of 2013-15; which was followed by three years of return to some kind of recovery; and later by the Covid-19 pandemic and now the ongoing Russia-Ukraine conflict (See article "Stability or Growth", Business Economics, November, 2022).

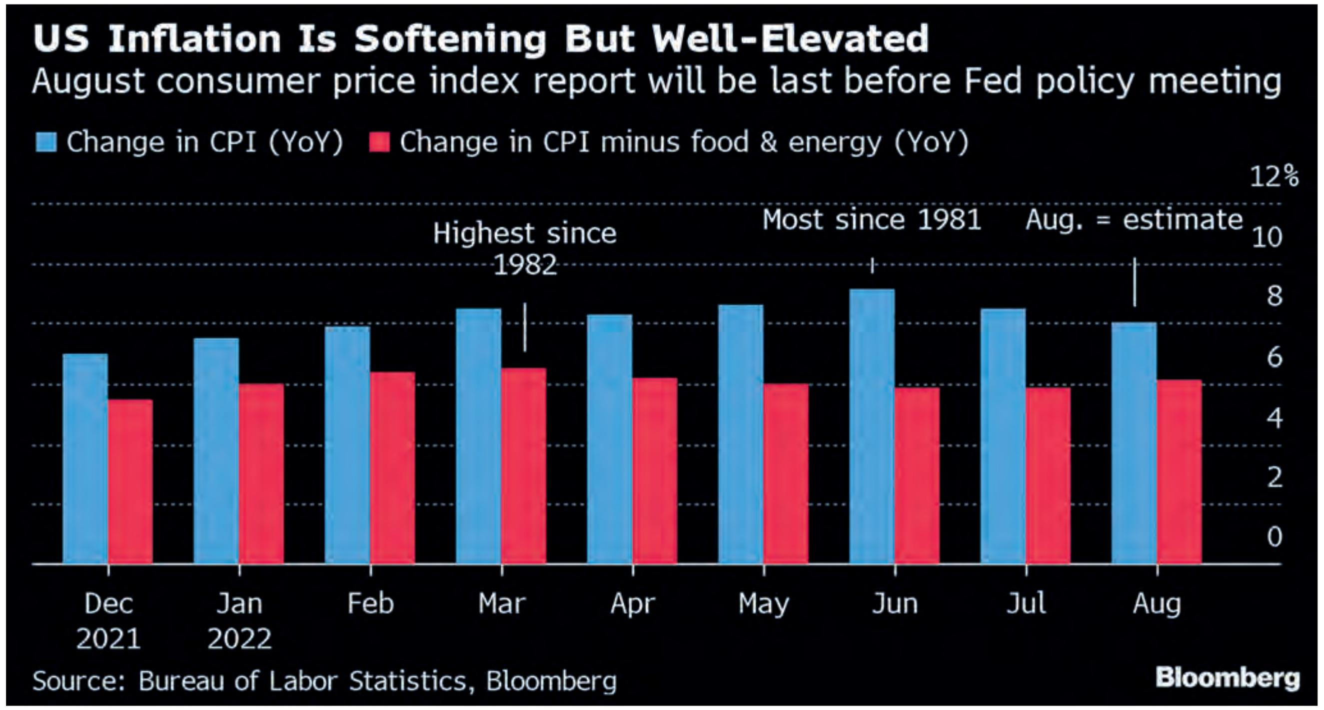
Impact on developing countries

Aggressive contractionary policy measures and synchronized interest rate increases by the US since May 2022 and followed later by other advanced countries have wrecked the poor economies. Uncertainties have also arisen about the likely recession due to fall in all components of aggregate demand, as private sector investment decreased due to high borrowing costs and fall in consumption of both semi and durable goods and frequently consumed manufactured goods following 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 the US and the rest of the world. Consequently, the US dollar has appreciated by more than 13% 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 to poor countries. The foreign exchange reserves position deteriorated in all poor countries. The EMEs with comfortable reserves including India intervening in the exchange market by selling dollars to arrest further fall in exchange rate. That led to reduction in the stock of foreign reserves held by EMEs.

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

Self-centered policies

The French philosopher, Albert Camus' words of the last century continue to hold good: "To be happy, we must not be too concerned with others." Economic policies of all advanced economies have always been self-centered and will be so. After World War II, financial leaders from 44 nations met in Bretton Woods, New Hampshire in the US to develop a new international monetary system that came to be known as the Bretton Woods system. Conference attendees had hoped that this new system would ensure exchange rate stability, prevent competitive devaluations, and promote economic growth. In 1958, the Bretton Woods system became operational when member countries agreed to set up two international institutions, the International Monetary Fund (IMF) and World Bank. The IMF is to deal with financial stability and solve balance of payment problems. A fixed exchange rate system was agreed to, under which the reserve currency was the US dollar. In other words, dollars



that could be converted to gold at a fixed exchange rate of $35 per ounce. 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 looking to import capital goods from the US: transport vehicles, iron and steel, machinery. The US was already 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 35% to 27%. In 1969, the US mounted a war against Vietnam, which was proving costly. Enormous fiscal expenditure which had to be funded by a rising public debt gave rise to the 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 the dollar. The US wanted that way so its trade balance would improve. In a fixed exchange rate regime, as currency was tied to gold, an overvalued dollar kept the cost of imports lower otherwise. So, France and Germany wanted their exports to the US to be settled in gold, not in dollars.

In France, the Bretton Woods was referred to as an asymmetric financial system. Professor Barry Eichengreen said: "It costs only a few cents for the Bureau of Engraving and Printing to produce a $100 bill, but other countries had to pony up $100 of actual goods in order to obtain one." In February 1965, President Charles de Gaulle declared his intention to exchange its U.S. dollar reserves for gold at the official exchange rate.

Nixon shock and Connally Stunning Words

By 1966, non-US central banks held $14 billion, while the US had only $13.2 billion in gold reserves. Of those gold reserves, only $3.2 billion was able to cover foreign holdings as the rest was covering the domestic holdings. In 1971, the US economy was in crisis with high inflation at 6%, GDP 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 the US Secretary in the Nixon Administration, John Connally administered what is now called the "Nixon Shock" to Europe: a 10% surcharge on all dutiable imports of US from Europe; a 10% reduction in foreign assistance to European countries in their defense preparedness against the then Soviet Union; 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 the 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 the gold standard, which was made official in December 1971. The rules of the gold standard were stringent. William Crowther, the celebrated British author of 'Money,' a delightful text book of the fifties of the last century, described gold standard as a jealous goddess who needs exclusive devotion.

You must 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 must inflate. There are automatic checks on public spending under the 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 or coin in trust.

The rest of the world knew then and now. There is no alternative to the dollar, as a reserve currency. Every nation's currency, including China and Russia and dictatorships and democracies, is linked to the US dollar. The only difference then and now is the value of world currencies are determined today at the market daily, round the clock, based on supply and demand forces. Good news, rise in petroleum crude output or 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.

The dollar is traded as a commodity as well: buy short and sell in the long! Holding more dollar reserves indicates the strength of any nation, outside the US. How it is acquired is important: legitimate earnings are through export of goods and services, including tourism and shipping and financial services; remittances and by attracting foreign private investment through good policies. They are certainly long term in nature. The long term is determined today! Healthy lifestyle for long and healthy life starts today, as medical experts and family doctors advise.

What do the international agencies, including IMF and World Bank, set up in 1944 advise now? Will the IMF and World also be subjected to reforms if needed? Will there be some more reserve currencies? Will the one-country dominance be diluted? Can G-20 or any regional groups emerge strong and democratize international finance in the midst of a growing volume of trade and rising mobility of labour and capital in the New Millennium?

They are the issues, which now need greater attention. ■

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