

Economist Insights

Just passing through

The effects arising from the close interplay of monetary policy and exchange rate policy are not uniformly felt across the world's economies. For the Fed, which enjoys the privilege of issuing the reserve currency, those effects are muted. Not so, however, for other Central Banks, such as the BOE, who must wrestle with the vagaries of exchange rate pass-through and the uncertainty which that can bring.

The 'great divergence' in monetary policy between the US and UK on one side and the Eurozone and Japan on the other brings with it another great divergence: in exchange rates. Expectations of higher interest rates in the US have pushed up the USD against the EUR by over an eighth in the last twelve months alone. The trade-weighted exchange rate of GBP is up by a tenth.

Monetary policy has been driving exchange rates, but exchange rates can in turn affect monetary policy. Economics 101 teaches us that a stronger currency should make your exports more expensive and imports from others cheaper, so you export less and import more. Lower net exports reduce GDP, slowing the economy. Even more importantly, those cheaper imports act to drive down inflation, which should mean less need to tighten monetary policy. Some commentators have been sceptical that the Fed can actually hike rates in the face of such a large appreciation.

The Fed, however, has traditionally pretty much ignored the exchange rate. Aside from a few comments from Fed speakers last year, and the short-lived mention of global demand in the September FOMC statement, policy seems to be driven by domestic considerations alone. Why does the Fed remain so blasé about the exchange rate?

It is all down to the exorbitant privilege of being the issuer of the world's dominant currency. A huge proportion of global trade is already priced in USD. Not only are virtually all commodities, and the vast majority of US trade, USD denominated, so is a large amount of non-commodity trade between other countries. Even countries that do little direct trade with the USA, such as India and Indonesia, have about three-quarters of their exports denominated in USD (chart 1). Only potential rivals for reserve currency status, like China, appear able to avoid USD dominance.



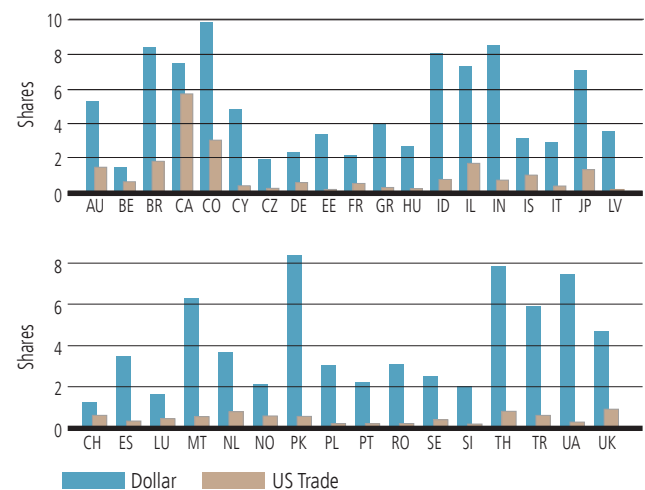
Joshua McCallum
Head of Fixed Income Economics
UBS Asset Management
joshua.mccallum@ubs.com



Gianluca Moretti
Fixed Income Economist
UBS Asset Management
gianluca.moretti@ubs.com

Chart 1: In dollar we trust

Share of country imports invoiced in dollars and traded with the US (%)



- | | | |
|---------------------|------------------|---------------------|
| Algeria = DZ | Hungary = HU | Portugal = PT |
| Argentina = AR | Iceland = IS | Romania = RO |
| Australia = AU | India = IN | Singapore = SG |
| Austria = AT | Indonesia = ID | Slovakia = SK |
| Belgium = BE | Ireland = IE | Slovenia = SI |
| Brazil = BR | Israel = IL | South Africa = ZA |
| Bulgaria = BG | Italy = IT | South Korea = KR |
| Canada = CA | Japan = JP | Spain = ES |
| China = CN | Latvia = LV | Sweden = SE |
| Colombia = CO | Lithuania = LT | Switzerland = CH |
| Cyprus = CY | Luxembourg = LU | Thailand = TH |
| Czech Republic = CZ | Mexico = MX | Turkey = TR |
| Denmark = DK | Morocco = MA | Ukraine = UA |
| Estonia = EE | Netherlands = NL | United Kingdom = UK |
| Finland = FI | New Zealand = NZ | United States = US |
| France = FR | Norway = NO | Venezuela = VE |
| Germany = DE | Pakistan = PK | |
| Greece = GR | Philippines = PH | |
| Hong Kong = HK | Poland = PL | |

Source: Gita Gopinat, The International Price System, NBER working paper n.21646

If most global trade is denominated in USD, an appreciation does not have much effect on the price of either US exports or US imports. So consumers may not notice much of the benefit arising from a stronger currency in the form of cheap imports, and exporters may not see much loss of competitiveness. There is little impact from the exchange rate. Compared to what other countries experience when their currency appreciates, US consumers lose out while US exporters benefit. Since there are no free lunches, this means that foreign exporters to the US benefit while foreigners importing from the US lose out.

With exports to the US priced in USD, exporters from various countries can effectively operate a cartel: even if the USD appreciation has pushed the USD price up relative to their domestic costs, prices do not change. So profits rise. In normal competitive markets exporters should start to undercut each other, but that is less likely when prices are anchored to the USD price. All this conspires to make exchange rate pass-through very much a secondary issue for the Fed.

Bank of Exchange-rate

The lack of exchange rate pass-through might not worry the Fed all that much, but no other central banks enjoy that exorbitant privilege of having the reserve currency. The Bank of England (BOE) is another central bank facing currency appreciation in anticipation of rate increases. Not only does the UK face all the usual shocks from exchange rate movements, but relative to the size of its economy trade is far more important than it is for the US.

Start with the price that foreigners exporting to the UK would charge in their own currency. This of course can go up and down with commodity prices, local wages, domestic inflation and so forth. Then when they convert the price of the goods they plan to export to the UK into GBP, that GBP price will go up when GBP appreciates, and down when GBP depreciates. So far, so straightforward. In 2007 when the price of exports to the UK denominated in foreign currency rose by about 6% (chart 2), the GBP equivalent rose by about four times that amount. This year the foreign currency price of exports to the UK were pretty much unchanged, but currency appreciation pushed the GBP price down by 5%.

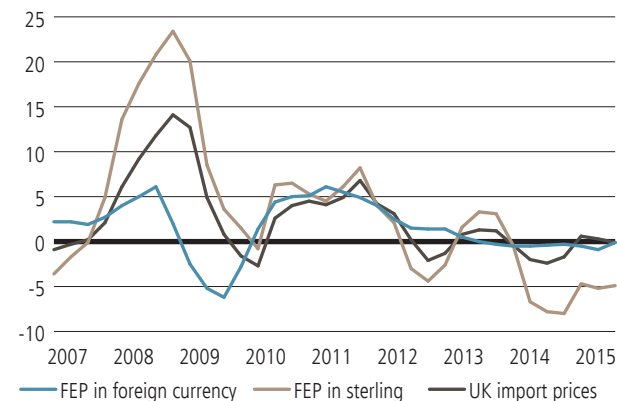
But now look at how much of that actually passed through to UK import prices. Pass-through does not need to be 100%: exporters do not like changing their prices too frequently, and some of the cost is transport and warehousing. In 2007-2008, it looks like about two thirds of the increase in the sterling price faced by exporters to the UK passed through to UK imports. This explains why inflation overshoot target. Then in following years pass-through was almost full, but that was because the change came from costs of production (exporters' costs), not the exchange rate.

But this year's appreciation of GBP appears to have had almost no pass-through to import prices. The currency movement should have pushed the GBP price of foreigners'

exports down by about 5%, but import prices for consumers are basically unchanged. In 2014 the pass-through was also very limited despite a hefty move in exchange rates.

Chart 2: In sterling we mistrust

UK foreign export prices (FEP) in both foreign currency and sterling, and UK import prices (ex oil and erratics) (% , yoy)



Source: Bank of England, ONS

Note: Domestic (and foreign) currency non-oil export prices of goods and services of 51 countries weighted according to their shares in UK imports, divided by the sterling effective exchange rate.

In short, sometimes there is a big pass-through from currency appreciation to UK consumer prices, sometimes there is a little and sometimes there is none. How then is the BOE meant to react to such an uncertain variable?

The first step is to try to understand why pass-through might differ. In their November Inflation Report the BOE point out that part of it may just be measurement issues, especially with the price that foreign exporters to the UK charge in their own currency. If they 'price-to-market' and charge different prices for different markets, then there may be more movement in prices for exports to the UK than the averaged data would suggest.

A second reason could be improving competitiveness from domestic UK producers. Foreign firms may absorb the hit to their profits by keeping prices lower so as to maintain market share. Then of course there is the point that almost half of UK imports are actually priced in USD, not GBP. And the USD is the one currency that GBP has not been appreciating against over the last year.

In short, the BOE cannot be certain that exchange rate pass-through might not resurface next year, especially if the Fed actually starts to raise rates. So the BOE has decided that the historical average pass-through of about 60% is a decent assumption. That means a continued focus on the exchange rate, and one could almost wonder if their policy is becoming increasingly driven by exchange rate considerations. One would have thought that the BOE's experience with exchange rate targeting in 1992 might have put them off the concept.