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Much ado about something important: How do exchange rate movements affect inflation?

In a speech today, Monetary Policy Committee member, Professor Kristin Forbes explores the flaws in our current understanding of the relationship between exchange rate movements and inflation. Talking to the annual Money Macroeconomics and Finance research group conference in Cardiff, Kristin argues that current models do not adequately consider the factors behind exchange rate movements. Instead, she proposes a new approach, resulting from her independent research, which places more weight on the underlying causes of exchange rate movements.

"Perhaps most important for monetary policy today, this approach also suggests that sterling's recent appreciation could create less drag on import prices and inflation than we might have expected if the levels of pass-through seen after the crisis persisted. If this plays out, monetary policy would need to be tightened sooner than based on older models."

Kristin begins by setting out the importance of understanding the implications of exchange rate movements for monetary policy. "They affect a country's competitiveness… overall prices and how far a pay check can go" and "can make it much harder (or easier) to repay debt denominated in foreign currency and affect any earnings on foreign investments." Although, as Kristin notes, "volatility in exchange rates is not unprecedented – or even unusual". She shows the importance of exchange rate movements to inflation, which makes the recent 17% appreciation in sterling's effective exchange rate particularly important for monetary policy. The effects of this appreciation, combined with any future movements is "a critically important determinant of when is the appropriate time to begin raising rates".

Kristin sets out three ways in which current models of calculating the impact of exchange rate movements on inflation do not seem to be working. Firstly, contrary to the academic literature "CPI components with higher import intensities do not seem to be systematically more sensitive to changes in the exchange rate." Likewise, "sectors which are more tradable and face greater international competition do not seem to be systematically more sensitive to changes in the exchange rate." And finally, "pass-through does not seem to be constant over time – even just the first stage of pass-through from exchange rate movements to import prices."

"This limited understanding of how exchange rate movements affect inflation is – to be candid – quite frustrating for those of us tasked to set monetary policy."

In considering what the missing piece could be Kristin suggests that "when analysing how exchange rate movements affect inflation, it is crucially important to consider a factor that has previously been largely ignored '….' – what drives the initial exchange rate movement."

For example, the recent appreciation has been driven partly by strong domestic demand, which has allowed UK companies to maintain sales without lowering prices as much in response to increased competition from abroad. Recent weakness in UK productivity has also played a role as "UK companies are likely finding it more difficult to reduce their prices to compete with cheaper imports than they would if ways had been found to raise productivity". This may explain why "there appears to be less pass-through from recent exchange rate movements today than occurred during the 2007/08 depreciation."

Kristin concludes "it is clear we need to rethink how we assess the impact of exchange rate movements on prices". In future "a better understanding of pass-through would improve our ability to forecast inflation and adjust monetary policy in advance as appropriate".

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