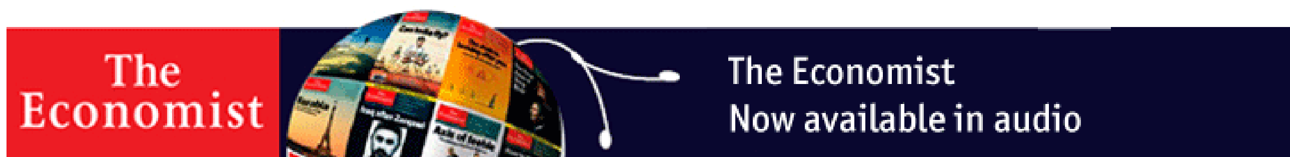

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A monetary malaise

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Central bankers helped cause today's mess. Will they be able to clean it up?

Illustration by Belle Mellor

FOUNDED in 1930, the Bank for International Settlements (BIS) is the oldest and chummiest of the international financial institutions. Based in Basel (with its famously good food), the central bankers' club is the nerve centre for international co-operation on monetary technicalities. How ironic, then, that the BIS's economists put much of the blame for the current mess on central bankers and financial supervisors.

For years, BIS reports have given warning about excess global liquidity, urged central bankers to worry about asset bubbles even when consumer-price inflation was low, encouraged policymakers in a global economy to pay more attention to global measures of economic slack, and argued that banking supervisors needed to look beyond individual firms to the soundness of the financial system as a whole. Today's calamity, in the BIS's view, stems from one fundamental source: a world where credit-driven excesses went on for too long. "The unsustainable has run its course," thundered the organisation's annual report in June.

The case against central bankers comes in two parts. The first is that they, along with other financial regulators, were asleep at the wheel, failing to appreciate the scale of risks being built up in the "shadow" banking system that modern finance had created. The second is that they fuelled a credit bubble by keeping money too cheap for too long.

The criticisms are most often directed at the Fed. This is because America is the world's biggest economy; because its interest-rate decisions affect prices across the world; because the Fed has shown a penchant for cheap money in recent years; and because America's mortgage mess fed the financial crisis. The Fed carries a disproportionately large weight among America's patchwork of financial regulators.

Supervision cannot work miracles, but the Fed clearly could have done better. It did not have direct jurisdiction over the independent mortgage brokers who were making the dodgiest loans during the height of the housing boom (they were notionally supervised by their states). But it had plenty of chances to sound the

alarm and could have calmed the frenzy by tightening federal rules designed to protect consumers. However, Alan Greenspan, the Fed's chairman during the bubble years, saw little risk in the housing boom and followed his hands-off instincts. His successors now admit that was a mistake. Supervision has been tightened.

What about monetary policy? Here the problem is the Fed's asymmetric approach. By ignoring bubbles when they were inflating, whether in share prices or house prices, but slashing interest rates when those same bubbles burst, America's central bankers have run a dangerously biased monetary policy—one that has fuelled risk-taking and credit excesses.

In the most recent episode the Fed stands accused of three main errors. Mistake number one was to loosen the monetary reins too much for too long in the aftermath of the 2001 recession. Fearing Japan-style deflation in 2002 and 2003, the Fed cut the federal funds rate to 1% and left it there for a year. Mistake number two was to tighten too timidly between 2004 and 2006. Mistake number three was to lower the funds rate back to 2% earlier this year in an effort to use monetary policy to alleviate financial panic. The first two failures fuelled the housing bubble. The third aggravated the commodity-price surge.

With hindsight, there is merit to the first two charges. The Fed did worry unduly about Japanese-style deflation in the early part of this decade, though it was a defensible decision at the time. The failure to tighten policy more quickly from 2004 onwards was a bigger mistake. Low short-term rates encouraged the boom in adjustable-rate mortgages that added to the housing bubble, and the predictability and gradualness of the Fed's eventual tightening encouraged broader risk-taking on Wall Street.

From a narrowly American perspective, the case against the Fed's rate cuts this year is weaker. Long before last month's calamities, the turmoil on Wall Street kept overall financial conditions tight even as the Fed slashed the price of short-term money. Because risk spreads have soared, borrowing costs for firms and individuals have barely budged even as lending standards have tightened dramatically. Given the economy's weakness, it is now hard to argue that the Fed was wrong to cut rates so enthusiastically this year.

But should the Fed be judged just by American criteria? Its actions—both during the bubble and the subsequent bust—took place against the backdrop of rapid financial globalisation and choices made by central bankers elsewhere. The most important of these was the emergence of large saving surpluses in many big emerging economies, especially China, and their (related) decision to link their currencies to the dollar, in a system often called the Bretton Woods II regime. (Bretton Woods I was the global monetary system in force between 1944 and the early 1970s under which countries fixed their currencies to the dollar, which in turn was tied to gold.)

Wall of money

The large saving surplus in emerging economies caused a flood of capital to rich ones, largely America. That surplus had several causes. Investment in many Asian economies collapsed after their financial crises in the late 1990s. The rapid increase in the price of oil over the past few years shifted wealth to oil exporters, such as Saudi Arabia and Russia, faster than they could spend it. But policy choices, especially emerging-economies' currency management, played a big role. The rapid rise in China's saving surplus between 2004 and 2007 stemmed in part from an undervalued exchange rate. Emerging-economy central banks now hold over $5 trillion in reserves, a fivefold increase from 2000 (see chart 9).

This flood of capital fuelled the financial boom by pushing long-term interest rates down. Long rates fell across the rich world and stayed perplexingly low even as the Fed (and other rich-world central banks) began raising short-term rates in 2004. Mr Greenspan famously dubbed this a "conundrum" but did nothing to counter it by increasing rates more quickly.

Eventually Bretton Woods II began to fuel credit booms and economic overheating in the emerging world. That is no surprise. When capital is mobile, countries that fix their currencies lose control over their domestic monetary conditions. When foreign capital flows in they must buy foreign currency and pay out their own one, increasing the money supply and stoking inflation. Central banks can try to keep foreign capital out, and can "sterilise" the effect of buying

foreign currency by selling bonds or forcing banks to hold higher reserves. Some countries, particularly China, have been surprisingly successful at this. But none of these methods works perfectly: eventually domestic credit takes off and inflation accelerates.

That is particularly likely when there is a large divergence in economic conditions between the anchor country (in this case America) and those that shadow its currency. The Fed's interest-rate cuts in late 2007 and early 2008 may have been appropriate for a weak and financially stressed American economy. But they sent the dollar tumbling and left monetary conditions far too loose in many emerging markets whose economies had long been growing beyond their sustainable pace.

By 2008, according to the IMF's estimates, emerging economies were growing above their trend rate for the fourth year in a row and had more than exhausted their spare capacity. Underlying inflation (excluding food and fuel) was beginning to rise. Everything pointed to the need to raise interest rates. Yet by March of this year short-term real interest rates in emerging economies (based on the weighted average of 26 central-bank policy rates) were negative (see chart 10). That suggests rising inflation was the consequence of a "decoupled" world economy in which emerging economies were booming even as America stumbled, and a misguided monetary regime that linked the two.

The upshot was a commodity-price spike and a rise in inflation the world over even as the financial crisis was deepening in rich countries. Ordinarily a banking crisis leads to disinflation (or even deflation) as asset prices fall, credit shrinks and economies slow. Yet in America, the centre of the storm, inflation rose this summer to levels not seen in almost two decades.

The role of commodity prices made the inflation risk hard to interpret. Central bankers had to decide whether the accelerating prices of food and fuel were a temporary surge in their price relative to other goods (in which case economic damage would be minimised by temporarily allowing overall inflation to rise); or whether the rising prices were a symptom of generalised price pressure (which would argue for higher interest rates).

Central bankers responded to this challenge in a variety of ways. Some emerging economies, particularly in Latin America, took an orthodox approach, raising interest rates quickly to get inflation back towards its target. Others, especially in Asia, took longer to adjust, even though wages were rising fast and demand was strong. Worried by double-digit inflation, some countries, such as India, eventually began to tighten sharply. Others, such as Malaysia, with inflation at 8.5%, did not budge.

In the rich world, central bankers in Europe were more worried about inflation than the Fed, partly because many pay deals in Europe are set centrally and wages have been more inclined to rise along with prices. The ECB raised interest rates in July, and Sweden's Riksbank increased them as recently as September. But everybody was perplexed by the combination of financial crisis and rising inflation. "I don't understand what the hell is going on," said one honest official in June.

In recent weeks those tensions have abated, though not in a comforting way. Global demand dropped sharply over the summer and the outlook for the world economy darkened. That slowdown helped to bring commodity prices down, transforming the inflation outlook in rich countries. Simple mathematics suggests that if oil prices

stay around $100 a barrel, headline inflation in the euro area could fall towards 2% within a year; in America it could be down to 1%. Since both these regions are in, or close to, recession, economic slack is increasing fast, which in turn will bring down inflation further. Add in September's financial calamities and the risk of entrenched and out-of-control inflation seems slim. Suddenly the idea of deflation—a generalised drop in prices—no longer seems far-fetched.

From inflation to deflation?

That is a worrying prospect. Deflation that reflects a slump in demand and excess capacity is always dangerous. Falling prices can cause consumers to put off purchases, leading to a downward spiral of weak demand and further price falls. That outcome is particularly pernicious in economies with high levels of debt, as Japan painfully discovered in the 1990s. The real value of the debt burden grows as prices fall—precisely the opposite of what a country needs when it is weighed down by excessive debts already.

The rich world's economies are already suffering from a mild case of this "debt-deflation". The combination of falling house prices and credit contraction is forcing debtors to cut spending and sell assets, which in turn pushes house prices and other asset markets down further. Irving Fisher, an American economist, famously pointed out in 1933 that such a vicious downward spiral can drag the overall economy into a slump. A general fall in consumer prices would make matters even worse. Since central banks cannot cut nominal interest rates below zero, deflation raises real interest rates, slowing the economy further and raising the real value of debts. Private-sector debts are now much larger than they were in the 1930s, so a modern depression could be even nastier. But there are four reasons why a deflationary spiral should be still a remote risk—and a risk that policymakers can avoid.

First, although food and fuel prices are volatile, most other prices do not drop so easily. In most rich countries "core" inflation is still a long way from zero. That will not change quickly. In Japan deflation did not set in until four years after that country's financial bubble burst.

Second, central bankers—at least outside America—have plenty of monetary ammunition left. At 4.25%, the ECB's policy rate still leaves plenty of scope for downward adjustment.

Third, American policymakers, at least, have understood that public money is necessary to counter a spiral of debt-deflation. They are now spraying taxpayers' money at the financial crisis like firemen with hoses. This will help slow the deleveraging.

Lastly, and less happily, several years of rising oil prices may have slowed the rich world's underlying economic speed limit, by reducing the productivity of energy-guzzling machinery and raising transportation costs. Economic weakness may therefore be less disinflationary than it used to be.

All in all, then, the rich world's policymakers have plenty of tools with which to beat off deflation. But just as the bubble was inflated by the interaction of monetary policy in the rich and the emerging world, so today's macroeconomic outlook will be influenced by decisions made outside America, Japan and Europe.

So far, emerging economies have been playing a positive role. If, as still seems likely, the biggest among them slow but do not slump, then some sort of floor will be put under commodity prices and robust consumers in the emerging world will prop up exports from fragile debt-laden rich countries.

But the emerging markets' resilience cannot be taken for granted. They suffered their own version of the cycle that Bretton Woods II inflicted on the rich world: surplus savings flowed in, stoking asset prices. Now many stockmarkets and currencies have plunged as the pendulum has swung back again. Investors worry about continuing high inflation (in emerging Asia) and lower commodity prices (in Latin America). Countries, especially in eastern Europe, that built up current-account deficits when cheap money made these easy to finance now look vulnerable. But the biggest economies, notably China's, appear robust. And if the world economy darkens further, China will emerge as the likeliest saviour.

China to the rescue?

China's government has already shown concern about its economic slowdown, lowering reserve requirements

for small banks and cutting interest rates. But from a global perspective it would be best for China to loosen fiscal policy and allow the currency to strengthen. The country has ample room to boost spending. And by allowing its currency to rise faster, it would counter the deflationary risks in the rich world as both the dollar and the euro weaken against the yuan.

Misguided currency rigidity helped cause today's mess; enlightened flexibility could help solve it. And in the longer term the lessons that emerging economies draw from today's turmoil will help define the direction of global finance.

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