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New policies for a new world

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Yesterday's financial architecture needs refurbishing

AMERICAN consumer spending and Chinese fixed investment have both slowed markedly in recent months. A synchronised slump in the two economies could nudge the world economy towards recession. America's and China's booms have been reinforcing each other. Low American interest rates encouraged capital to flood into China, fuelling its investment boom, and American consumers bought lots of Chinese exports. At the same time, America's imports of cheap Chinese goods and cheap Chinese capital (in Treasury bonds) have held down inflation and interest rates and so supported its spending binge. However, the resulting excessive consumption in America and excessive investment in China have both become unsustainable.

Most commentators still hope that the Chinese authorities can achieve a soft landing, but investment booms typically end more painfully. This survey has argued that even if China suffers a sharp slowdown over the next year or so, its long-term growth prospects remain good. But to minimise the future risk of excessive booms and busts, China needs to reform its banking system to ensure a more efficient allocation of capital, and to make its exchange rate more flexible to regain control over its monetary policy.

America's immediate challenge is to increase interest rates without causing over-indebted consumers to take fright. Artificially low interest rates have encouraged households to

save too little and borrow too much. The risk is that as short-term interest rates return to normal levels of 4-5%, the housing bubble with its attendant mortgage-refinancing bubble will burst, exposing the flimsy foundations of America's recovery.

The longer-term challenge for the Fed and other central banks is to build a new monetary-policy framework that takes account of recent structural changes in the global economy, such as the integration of China. For more than two decades, central banks' main task was to fight inflation. Now and in the coming years, the banks will increasingly have to deal with booms and busts in credit and the prices of assets such as homes and shares.

Cheaper goods from China, combined with faster productivity growth thanks to IT, have held down inflation, and excess liquidity has instead been bottled up in asset markets. At the same time, a long period of low inflation has anchored inflationary expectations, so prices and wages are less likely to take off if demand grows faster. With inflation under control, central banks are inclined to keep interest rates low and thereby unwittingly accommodate an unsustainable boom in credit and asset prices.

Asset-price inflation is just as harmful for economies as inflation in the prices of goods and services. Just as conventional inflation can distort the allocation of resources, so asset-price inflation distorts economic behaviour by causing households to save too little and to pour too much money into property. Booms and busts in asset prices can pose as much of a threat to economic stability as conventional inflation.

The recent surge in house prices around the world has revived the debate about whether central banks should raise interest rates to cool down asset inflation. The Federal Reserve's Alan Greenspan has declared himself fully vindicated in his decision not to prick the stockmarket bubble in the late 1990s, but instead to wait for it to burst and then cut rates sharply to cushion the economic consequences. A central bank, he argued, cannot be sure that it is really dealing with a bubble until it has burst, and raising rates by enough to prick a suspected bubble could itself set off a deep recession.

Claudio Borio, an economist at the BIS, and Philip Lowe, at the Reserve Bank of Australia, have tried to shift the emphasis of this debate away from the question of whether central banks should prick a bubble. Instead, they look more broadly at financial imbalances, particularly excessive growth in credit, which tends to signal problems ahead. Their analysis suggests that large simultaneous deviations from trend in both the growth of credit relative to GDP and in real asset prices are usually good predictors of financial strains and can provide useful information about future output and inflation.

If it is possible for central banks to identify the build-up of financial imbalances in good time, then they can restrain those imbalances, rather than just waiting to offset the economic consequences of their unwinding. Messrs Borio and Lowe argue that central banks need to pay more attention to excessive growth in credit even when inflation is subdued. Thus they might set broad targets for credit growth alongside an inflation target.

An increasing number of central banks, such as the Bank of England, the European Central

Bank and the Reserve Banks of Australia and New Zealand, now support the view that monetary policy should sometimes act to restrain a rapid increase in credit and asset prices. Indeed, this was one of the main justifications for raising interest rates in Britain this year. Likewise, the ECB has pointed to the "second pillar" of its monetary-policy strategy, which monitors growth in money supply and credit, to explain why it did not ease policy more. Otmar Issing, the bank's chief economist, argues that central banks cannot afford to ignore asset prices and credit. Among the main central banks, only the Fed still seems to reject this advice.

Time to join the club

Another way in which today's rich economies need to adjust to China's integration into the world economy is to include the country in international economic-policy forums. Absurdly, China is not a member of the G7 group of finance ministers and central bankers (which embraces America, Japan, Germany, Britain, France, Italy and Canada) or the G8 (which also takes in Russia). When the G7 was set up in the 1970s, the current members did call the shots on global growth, trade and currencies, but today China's economy, even if measured at market exchange rates, is bigger than that of either Canada or Russia, and measured at PPP it is already the second-biggest. China is also the world's third-biggest trader, and holds the largest foreign-exchange reserves after Japan.

At most of their meetings over the past year, G7 finance ministers have called on China to make its exchange rate more flexible. Yet China has not been present to take part in the discussion. At the G7 meeting in Washington in early October it will be hovering at the fringes, but it should now be offered full membership. Without it, the G7 will soon become an irrelevance.

Bringing China into the G7 might also be a good way to discourage protectionism in America and Europe as China's exports continue to expand. Economic relations between America and China are already strained because of concerns about America's big trade deficit and its job losses. China is the biggest target of American anti-dumping duties, which cover around 60 Chinese products. A proliferation of trade barriers would block the world's most powerful source of future prosperity.

Instead, developed countries should concentrate on maximising the gains and minimising the losses from China's development. That requires open product markets, flexible labour markets and better education and training to help workers who lose their jobs find new ones. Membership of the G7 would also give China a bigger stake in the smooth functioning of the global economy. Current spats about its exchange rate are insignificant compared with the risk to the world economy if this powerful engine of growth were to break down or even close its borders again.

There are some worrying similarities between today and the early 1970s, when the emergence of a new economic giant, Japan, was widely seen as a threat to jobs elsewhere; commodity prices were also rising rapidly and monetary policy was too loose.

In response, other countries became more protectionist, and inflation took off, leading to slower and more volatile growth. The world cannot afford to make the same mistake again.

Asked about the effect of the French Revolution on world history, Zhou Enlai, China's prime minister from 1949 to 1976, is said to have replied: "It's too early to tell." With luck, the benefits of China's economic revolution will become obvious much more quickly.

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