

ECONOMICS FOCUS

Economics focus

Heading for a fall, by fiat?

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The trouble with paper money

IS THE problem with the dollar only that it is falling? It has certainly been doing that. This month, it fell to \$1.29 against the euro. This is its lowest-ever rate against the euro, and represents a decline of 19% since the beginning of 2003. In trade-weighted terms, the dollar has fallen less over the same period (15%), but mainly because Asian central banks have been intervening heavily to stem their currencies' rise against it. Of late, it has been wobbling around unconvincingly: America needs a weaker dollar to correct its current-account deficit. But given the dollar's role as a currency of last resort, some wonder if its decline heralds not just an economic adjustment by the United States, but a crisis of sorts in the value of paper money itself.



Money in its present form is a relatively new invention. For most of human history money meant either gold or silver, either directly, or indirectly by means of the "gold standard" which meant, at least in theory, that all paper money was backed by gold. Enthusiasm for the gold standard evaporated in the 1930s, when it made dreadful conditions worse. But it was adopted in a watered-down version after the second world war, when only the dollar was backed by gold. This arrangement made some sense, since America held three-quarters of the world's gold stock. But it came to an end in 1971, when inflationary pressures in America caused the country's manufacturers to become uncompetitive and forced the country off the gold standard. Since then the world has relied on "fiat money", so-called because it is created by government fiat and is backed only by the promises of central bankers to protect the value of their currencies. It is the value of those promises that some are now questioning.

Promises, promises

Certainly, those promises have only been worth much in recent years. In the early years of fiat money, inflation took off, especially in America, in part because of the two oil shocks of the 1970s. This debased the value of the dollar, and the price of gold climbed from \$35 an ounce to \$850.

It was only in 1979, in his famous "Saturday night special", that Paul Volcker, then chairman of the Federal Reserve, raised interest rates sharply to clamp down on inflation. The gold price subsequently fell sharply and in its place came a bull market in government bonds that has, with a few sharp interruptions, continued to this day. Although central banks around the world still hold about 30,000 tonnes of gold in their reserves, many have been offloading their stocks over the years. They can earn only a nugatory rate of interest on these stocks (by lending them out) compared with what they can earn on government bonds. For most people, gold has been relegated to the status, in the words of Keynes, of a "barbarous relic"; its price has risen only feebly when investors have fretted about inflation.

Those who doubt the continued worth of paper money as a store of value point to two things. The first is that the price of gold has been rising even though official inflation is low. From \$253 an ounce in the late 1990s, gold now fetches just over \$400 an ounce, and it rose as high as \$430 an ounce earlier this year. It is not just the price of gold that has been rising: so, too, have the prices of precious and base metals. There may, of course, be many other reasons for these rises. China's rapidly expanding economy is gobbling up metals and other commodities for its factories. Moreover, the rise in the price of commodities also reflects the weakness in the dollar: these rises look much less impressive when quoted in euros or yen. But the rise in the price of gold in particular has raised questions.

The biggest of these—and the second main reason for concern—is the amount of debt that rich-country governments have been running up. America's official budget deficit has surged in the three years since George Bush became president, to around \$520 billion and climbing. But this is just the shortfall this year. The government's total future liabilities are much larger. In fact, according to a forthcoming book by Laurence Kotlikoff, an economist, the present value of the American government's future obligations, taking into account promised pensions and health-care benefits, is a staggering \$45 trillion. European governments are only slightly better at managing their budgets—witness the breaching of the single currency's growth and stability pact. Japan's attempts to coax its economy back to life have left it with a gross national debt of some 160% of GDP, the highest of any big country. No country has tried harder to debase its currency.

In theory, such debts would not be tolerated for long by investors, since the easy way out for central banks is to "monetise" them with inflation. Bond prices would fall (and thus yields rise) as investors worried that they would be paid back in a debased currency. But capital markets currently seem oblivious to spiralling debts. At some 4%, yields on ten-year American Treasury bonds are close to their lowest in two generations, although this is partly explained by huge purchases by Asian central banks. Yields elsewhere are also very low, nowhere more so than in Japan, where ten-year government-bond yields are now

1.3%.

The problem may be that bond investors, far from being far-sighted, are in fact myopic, and are perhaps being fooled by the temporary disinflationary effects of excess capacity and debts built up over the bubble years in both Japan and America. Perhaps, too, investors have been lulled into a false sense of security by the performance of central banks in recent years, and the independence that has been granted to many of them by governments. But this very aura of inviolability may be storing up problems, since it means that governments can borrow still more at cheap rates. And if governments then find themselves crushed by debt, you can rest assured that this independence will be taken away. And then, once again, the paper in your pocket will only be as good as a politician's promise.

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