Independent central banks have never been so powerful. But how might increasing global economic integration affect that power?

“THERE have been three great inventions since the beginning of time: fire, the wheel and central banking,” Will Rogers, an American humorist, once quipped. Last week in Jackson Hole, Wyoming, the first and third of these great inventions did battle, and the central bankers won. Nearby forest fires did not prevent central bankers from around the world from gathering for the annual symposium of the Federal Reserve Bank of Kansas City.

The theme of this year’s meeting was global economic integration. Will economies continue to be integrated by flows of trade and capital? And if so, what will be the effects on economies and on central banks? On the first question, there was disagreement. Michael Mussa, the research director of the International Monetary Fund, argued that the risk of a return to isolationism was small. But Alan Greenspan, the chairman of America’s Federal Reserve, was less cheery: if global growth were to stall, protectionism might well return.

But put aside his pessimism as rational prudence, and take the optimistic view: that the globalisation of goods and capital markets continues. Though this would bring big benefits to the world economy as a whole, it makes the job of central bankers harder in several ways.

For a start, monetary conditions in one country are now increasingly affected by developments abroad. In the first half of the 1990s, for example, low interest rates in rich economies caused investors to seek higher returns in East Asian economies. Massive inflows of foreign capital stoked up domestic demand, but Asian central banks failed to respond by tightening monetary policy and allowing exchange rates to rise. The result was that economies overheated and financial bubbles inflated. Another example of foreign influence on domestic monetary conditions was in 1998, when the Federal Reserve cut interest rates because the turmoil that followed Russia’s bond-default threatened a credit crunch.

Another way in which globalisation has affected monetary policy is by changing the channel through which interest rates affect demand. Their impact on the economy via the exchange rate has become more important relative to their direct effect on borrowing. As trade expands as a proportion of GDP, so a given movement in the exchange rate has a bigger impact on demand and inflation.

At the same time, the increased mobility of capital has also made exchange rates more sensitive to cyclical developments. Fast-growing economies, such as America’s at the moment, tend to see their exchange rates appreciate as foreign money floods into the market that seems to offer the best return. Since a rising dollar has
helped to hold down American inflation, the Fed has needed to raise interest rates by less than it otherwise would. The catch is that this may encourage share prices and borrowing to rise to unhealthy levels. The rise in the yen had similar consequences in Japan in the late 1980s—before the bubble burst. Thus global forces may help to hold down the prices of goods and services, but at the increased risk of inflation in asset markets.

Nor are things easy when central bankers don their regulatory hats. Economic integration has blurred the geographic boundaries between markets and between financial institutions. And the creation of global financial institutions has complicated the task of financial supervisors.

**Cast afloat**

Central bankers in Jackson Hole largely agreed with the new consensus that in a world of highly mobile capital, countries must opt for either a fully fixed exchange rate—against the dollar or the euro, say—or floating exchange rates. Any halfway arrangement will sooner or later hit the rocks. European monetary union aside, many countries have opted to float in recent years. But here’s a funny thing: if they really intend to stick to a free float, why are central banks still sitting on massive foreign-exchange reserves?

The holding of large official reserves is a hangover from the Bretton Woods system of fixed exchange rates, under which countries were obliged to defend their parities through official intervention. Yet Bretton Woods broke down almost 30 years ago, and the shift to floating exchange rates and the expansion of international capital markets, which has improved countries’ access to foreign borrowing, should have reduced the need to hold reserves. But global foreign-exchange reserves are now higher in relation to trade flows than at almost any time in history. The ratio of foreign-exchange reserves to imports has risen from 12% in 1969 to 30% this year.

Reserves are traditionally seen as a sign of a country’s financial strength. But just as a firm that kept lots of spare cash sitting idle in the bank would be considered badly managed, so should a central bank that keeps too much money in low-yielding treasury securities—let alone gold.

New Zealand has not intervened in the foreign-exchange markets since March 1985 when its currency was floated. A few years ago, the country’s central bank even toyed with the idea of eliminating its foreign-exchange reserves altogether, but it rejected the idea. Central banks still need some reserves to plug temporary gaps in the demand and supply of foreign exchange. Still, most countries do not need to have war chests as large as they are now.

With one exception, thought Martin Feldstein, from Harvard University. He argued that emerging economies would be wise to hold even bigger reserves to reduce the risk of future financial crises. To minimise the opportunity cost of holding reserves, he suggested they could invest the money in some sort of global equity fund. A good idea? Imagine a central banker having to explain why a country’s reserves were wiped out by a stockmarket crash.