FINANCE & ECONOMICS

Buttonwood

Birth pains

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A new global system is coming into existence

Illustration by S. Kambayashi

ALL monetary and economic systems are a struggle between borrowers, who favour inflation, and creditors, who are determined to maintain the purchasing power of the currency. In a democracy, this is a very fluid battle. The creditors have the money and therefore the ear of the political elite; the borrowers tend to have the votes.

Creditors have periodically imposed monetary anchors in an attempt to defeat the borrowers' lobby. These anchors are devised in prosperous times but run into difficulty during recessions. The gold standard failed to outlast the Depression. For nations with a shortage of gold, the "right" thing to do was to raise interest rates in an attempt to lure gold back; the austerity this imposed on the rest of the economy was politically unacceptable.

The Bretton Woods era replaced a gold standard with a dollar standard (albeit with the American currency theoretically linked to bullion). The system worked well for more than two decades, helped by the post-war economic boom, particularly in Germany and Japan which began the period with undervalued exchange rates. It broke down because America refused to pay the domestic price for bearing the system's weight.

When Bretton Woods failed, it was not immediately obvious what would replace it. European nations, in particular, maintained a hankering for fixed exchange rates. But floating rates eventually prevailed, particularly for the major currencies of the dollar, yen and D-mark.

The problem for creditors was that the floating-rate system was based on fiat (paper) money. What would keep the inflationary instincts of governments in check? The answer took a couple of decades (and recessions) to hammer out.

Once it was accepted that the markets could set exchange rates, there was no real need for capital controls. And once capital could flow freely, ill-disciplined governments could be punished by higher bond yields. Politicians accordingly tried to reassure the markets by giving greater power to central banks, some of which set explicit inflation targets.

The post-Bretton Woods system worked well, engendering the long period of low inflation and steady growth known as the Great Moderation. But one of the reasons for its apparent success—the growth of India and China—may have sparked its demise. The addition of these two great nations to the international financial system was a supply shock that put downward pressure on inflation rates.

As Stephen King, an economist at HSBC, has pointed out, the result might have been a benign deflation that boosted Western living standards. But central banks struggled to avoid a deflationary outcome; the result was a loose monetary policy that encouraged asset bubbles. Those bubbles lasted longer than expected because the flood of savings from developing markets held down the risk-free rate.

Now it seems to be recognised that inflation targeting is not enough. Given the explicit government guarantee behind the banking system, central banks need to monitor both financial stability and asset prices. At the same time, some central banks have adopted (via quantitative easing) a policy of creating money to boost markets that also has the convenient side-effect of funding budget deficits. That is just what opponents of fiat money feared would happen in the long run.

The same old dilemma will eventually occur. Having spent a fortune bailing out their banks, Western governments will have to pay a price in terms of higher taxes to meet the interest on that debt. In the case of countries (like Britain and America) that have trade as well as budget deficits, those higher taxes will be needed to meet the claims of foreign creditors. Given the political implications of such austerity, the temptation will be to default by stealth, by letting their currencies depreciate. Investors are increasingly alive to this danger; ten-year Treasury bond yields are around a percentage point higher than they were at the start of the year.

Creditor nations tend to set the rules and the new global monetary system will be unable to operate without the approval of China, a creditor country that has capital controls and a managed currency. It has been assumed that China will have to move towards the Western model. But why not the other way round? Western countries adopted free capital markets, as the British adopted free trade in the 19th century, because it suited them. Will China now be able to call the shots? Uncomfortable as it might be for the West, the next monetary order is more likely to be made in Beijing than in New Hampshire.

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