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The Global Repercussions of Changes in US Monetary Policy

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The ongoing interest rate cuts in the US are risky for both the US and the global economy. The international dimension of the decisions taken by the Federal Reserve Board is being underestimated by most market analysts and commentators, whose focus seems to be largely how the rate cuts affect individual countries. Attempts to analyze the potential transmission effects of the US subprime mortgage crisis on other economies concentrate on the demand channel (how the expected US slowdown will influence growth in other countries/regions) and the financial sector contagion (losses in some large banks, the spread of negative market sentiment as observed this past summer). Monetary policy and inflation developments have attracted much less attention.

Bailing out the troubled financial sector

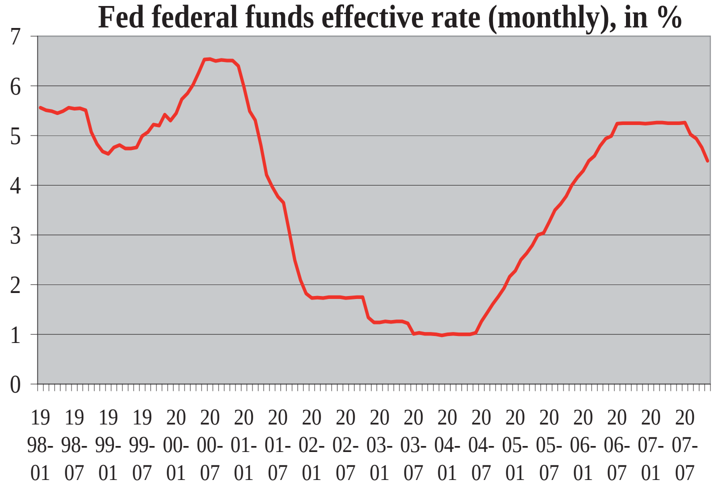
This is not the first Fed reaction to these kinds of financial market tensions. In the last decade only, at least two episodes spring to mind. The first is the monetary easing that occurred after the series of emerging-market crises (Mexico, South-East Asia, Asia, Russia, pre-crisis situation in Brazil) and the LTCM[1] troubles in the US at the end of 1998. The second is the major interest rate cuts of 2001-2002 (to the level of 1%) after the tragic events of September 11th and the bursting of the dot com bubble. In both cases, the Fed's decisions provided some relief to troubled financial institutions, helped to avoid (1998) or reduce (2001) the danger of a US recession, and aided overall global economic growth.

However, in both cases, the decisions contributed to building macroeconomic bubbles and distortions. The first cut helped to build the dotcom bubble in 1999-2000, which was followed by its sudden burst in 2001. The second one moved the bubble from the stock market to the real estate market, which is causing the current troubles. Both decisions contributed to a continuous decline of private saving rates in the US economy and to the ballooning of the current account deficit.

Fears of recession

Now, once again, monetary policy is being aggressively eased with the aim of avoiding recession and giving troubled financial institutions more breathing space to recover. Is this the right decision? Can the US economy continue to develop without a recession for almost two decades? The answer depends on the time horizon. In the short term, there is a large possibility that the Fed can repeat the same fine-tuning maneuver a third time and the US economy will sustain a positive, yet not very high, growth rate. However, the costs for both the US and global economy in the medium-to-long term may prove even more serious than before. There are a few obvious negative consequences such as the moral hazard (created by any bail-out operation) and the continuation of a large saving-investment imbalance (determined by low interest rates and excessive demand for credit). Nevertheless, the key question remains: How will the excess liquidity be absorbed? The last two times it was absorbed by asset prices (stock and real estate, which ended up with bubbles) and the increasing external demand for US dollars. This time, the US and global price stability will

Fed federal funds effective rate (monthly), in %



http://www.federalreserve.gov/datadownload/Build.aspx?rel=H15

most likely fall victims to this excess liquidity. The existing imbalances will not disappear and US monetary policy will have to be tightened yet again – probably in an even less comfortable macroeconomic situation and at higher output/employment costs than today. Delaying difficult

1 Long-Term Capital Management (LTCM) was a hedge fund founded in 1994 which was initially very successful with annualized returns of over 40% in its first years. In 1998 it lost $4.6 billion in less than four months and became a prominent example of the risk potential in the hedge fund industry. The fund folded in early 2000.

decisions and adopting half-measures never pays off in economic policy making.

Leaning against the wind

There are, however, two fundamental differences between the 1998 and 2001 episodes and the current situation. In 1998, the USD was continuously appreciating against other currencies, indicating insufficient global liquidity. The series of currency crises in emerging markets and declining oil and commodity prices in the 1990s serve as more indirect evidence that demand for the only truly global currency at the time exceeded its supply. In the case of the 2001-2002 episode, commodity prices, particularly oil, were already increasing and the US current account deficit seriously widened, signaling the accumulation of domestic imbalances. However, the dollar continued its nominal appreciation and consumer price indexes reached historical lows in most countries. The global economy benefited from the major supply shock resulting from economic reforms and the opening up of China and India and other developing and transition countries. The liberalization of world trade originating from the so-called Uruguay round also added to downward price pressure, at least on the manufacturing market. Some economists began warning about the danger of deflation, though in hindsight, these concerns now seem greatly exaggerated. Thus, in both cases (although less so in 2001-2002), one could say the US monetary stimulus met the increasing demand for a global currency.

The current situation is completely different. It is marked by excessive global liquidity and increasing global inflationary pressures. In addition, one cannot expect a repetition of the anti-inflationary supply-side shocks which were observed in the early 2000s. Negotiations on further liberalization of global trade have been stalled, and energy and commodity markets are very tight.

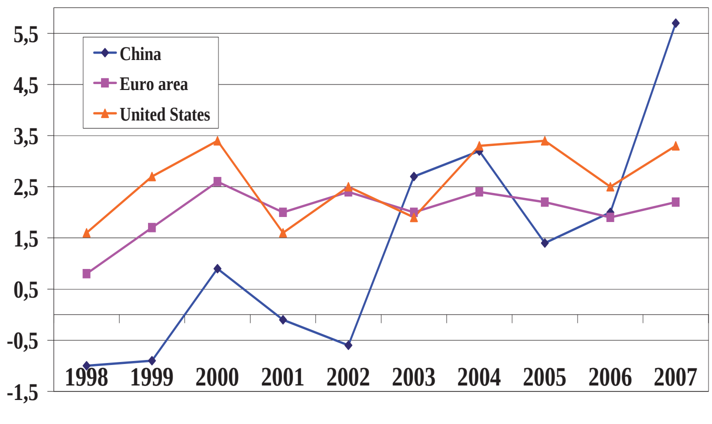
Inflationary pressures have not been noticed on consumer markets for a long time and therefore have not been captured by CPI - the official inflation measure. The excess liquidity was being absorbed largely by assets markets in developed countries and growing commodity prices. Yet recently, both official headline and even core inflation indicators[2] present a clearly increasing trend in most countries. Several economies are obviously overheated. This is why many central banks started tightening monetary policy a few years ago and why this trend should be continued.

Adding to inflationary pressure

In this situation, the Fed policy leaves other central banks with a difficult choice: either follow the Fed and accept higher inflation in their currency areas or resist this temptation and risk the appreciation of their own currencies. The former involves the danger of losing the inflation target and of undermining the central bank's credibility as well as the perspective of even tighter monetary policy in the not-so-distant future. The latter means undermining the competitiveness of countries' own producers and the possibility of output and employment losses in the short-term. The two divergent decisions, both taken on the same day (December 6, 2007) by the Bank of England (which cut its basic interest rate) and the European Central Bank (which left its monetary policy stance unchanged), accurately reflect this dramatic dilemma.

However those central banks which target their exchange rates to the USD (even as a partial or soft peg) face an even more dramatic challenge. If they want to avoid importing an inflationary impulse via a weakened US currency, they must abandon the dollar peg immediately. This dilemma concerns many central banks in Asia (most notably China and India), oil exporting countries (especially those of Gulf region), CIS (Russia, Ukraine, Kazakhstan and others), and some countries in Latin America and Africa. This is perhaps easier and faster to do in the case of large economies such as China, India and Russia. It may not prove so easy in the case of smaller economies, which have a higher exposure to international trade and many of which are experiencing a high level of actual dollarization.

End-of-year inflation in %



Source: http://www.imf.org/external/pubs/ft/weo/2007/02/weodata/index.aspx

In fact, the process of departing from a dollar peg has already started. It is taking various forms: switching from the dollar anchor to the Euro or to a basket of currencies, widening fluctuation bands, or accepting a "crawling peg" appreciation vis-a-vis the dollar. However, these actions are usually delayed and insufficient. The recent acceleration of dollar depreciation against other major currencies calls for more radical actions in this respect.

Flight from the dollar

The consequences of a falling USD do not only affect formal exchange rate arrangements. The dollar is the global unit of accounting and statistical reporting, the dominant currency of trade and financial transactions, and a means of storing financial wealth (including international reserves of central banks). These spheres are already and will continue to be affected by the declining international value of the USD.

2 Core inflation indicators used to eliminate, at least temporarily, the impact of commodity price changes on inflation.

All who use the dollar as an accounting unit will report rapidly increasing sale prices and revenues as well as dollar-denominated profits. This may create an illusion of money and wealth in the short term, which could lead to overly optimistic financial and investment plans, if one does not make an adjustment based on the declining international value of US currency. The same may happen on a macro level, especially in those countries, which continue to peg their currencies to the USD. They may face the illusion of increasing tax revenues as in, for example, the case of rent-type taxes linked to dollar-denominated export prices, or growing international reserves.

Looking at financial transactions, holders of dollar-denominated assets will lose and holders of dollar-denominated liabilities will gain. Central banks holding large dollar-denominated reserves will be the major losers. Sovereign wealth funds created by oil exporters and some Asian countries in order to sterilize excessive foreign exchange inflows will be the next victims. However, numerous private holders of dollar-denominated financial assets worldwide will also have to bear exchange rate losses and inflation tax. On the other hand, the US private sector (especially households) and the US government, who are the largest debtors in US currency, will be major beneficiaries. Similar gains will be shared by all other holders of USD-denominated liabilities. This may not necessarily be the best lesson for potential borrowers in less-developed countries as it may lead to increasing their appetite for future foreign-currency borrowing.

The key question however, is whether holders of dollar-denominated assets will quietly stay put or start to run out of US currency. Until very recently, the prevailing opinion was that, assuming a modest and gradual dollar depreciation, no dramatic re-composition of at least official assets would occur. However, this assumption does not hold true any longer. There is increasing evidence of central banks and sovereign funds seriously thinking about changing the denomination of their assets. Abandoning the USD peg may also lead to decreasing demand for dollar-denominated official reserves, which would further add to the USD depreciation trend.

The end of a global currency?

Looking ahead, one must ask whether the USD will sustain its role as the most important global currency. If not, which currency will take over? Today, the euro seems to be the most likely successor. But whether member countries of the European Monetary Union (EMU) and the European Central Bank (ECB) will be happy with such a perspective remains an open question. Issuing a global currency offers the privilege of earning more seigniorage and easy access to external financing, but also requires taking into account the needs of the global economy. The Fed experience demonstrates that domestic and global policy considerations may sometimes differ dramatically.

The failure of the USD to perform the role of a firm anti-inflationary anchor makes not only the rationale of dollar pegs, but any hard pegs such as a currency board or unilateral dollarization/euroization, questionable. If the USD is suffering a credibility crisis today, any other currency (including the euro), may experience the same problems tomorrow. Does this mean that the floating exchange rate and inflation targeting (as advertised by IMF) is the only rational solution in today's turbulent world? As mentioned above, this may be a good solution for large economies, but much less so for smaller ones and those which lack sufficient credibility.

A global float would make the job of those central banks whose currencies already float (like the euro or yen) much easier. If all currencies were already floating against the USD, then the dollar's weakening would have been accommodated more evenly and smoothly. However, a global float and the lack of a global currency may add to transaction costs in international trade and financial markets and slow down the globalization process and global growth prospects.

Policymakers and analysts should be aware that this is not just another case of counter-cyclical fine-tuning, but a serious policy turning point, which can have serious systemic consequences for the entire global economy (due to the special role of the USD as the global currency). Economists could benefit by studying previous episodes of major changes in the global monetary system, such as abandoning the gold standard and the subsequent collapse of the Bretton Woods system. Yet the question that begs the most immediate answer now is whether or not to continue interest rate cuts in the US. The answer is decidedly negative.

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