Martin Wolf: The Fed is forced to fuel a global boom

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You may think the Federal Reserve is the US central bank. But it is much more than that. It is the central bank of more than half the world. That explains much of what is happening in the world economy. Fed policies are driving the rest of the world quite as much as the US.

Today, the world's important economies are divided into those within a zone of fixed or quasi-fixed exchange rates against the US dollar and a zone of currencies that float relatively freely against it (see charts). In the 1960s, the European and Japanese currencies were tied to the US dollar via the system established at the Bretton Woods conference of 1944. Now, Asian currencies are tied, more or less informally, to the dollar.

This illuminating description of the global monetary regime was advanced by Michael Dooley of the University of California at Santa Cruz and David Folkerts Landau and Peter Garber of Deutsche Bank in a paper published last September.* They have followed it up with a new one.** The Asian tail, they argue, is wagging the US dog.

This new dollar zone can be divided into a US core, an inner circle and an outer circle. The inner circle contains currencies tied very closely to the US dollar. The outer circle includes currencies whose movement is constrained by large-scale intervention (see chart). The former group consists, above all, of China: the US and China are in effect one economy. The latter adds India, Indonesia, Russia, Singapore, South Korea, Taiwan and Japan. The inner circle generates 35 per cent of world gross domestic product, of which 31 per cent is inside the US, and contains 26 per cent of world population, of which 21 per cent is in China. The outer and inner circle generate 53 per cent of world GDP and contain 52 per cent of world population. Together, the US and Japan generate 42 per cent of world GDP, while China and India contain 38 per cent of world population.

What are the implications of the emergence of this dollar zone?

First, the Fed's aim is to expand the US economy until it reaches full employment. But to do so it must stimulate the whole of this vast dollar zone: a proportion of the extra spending that the US authorities generate spills directly over into imports and so expansion abroad; but dollar-zone economies are also stimulating their economies by keeping interest rates low and intervening heavily in foreign currency markets. Developing members of the dollar zone have easy access to advanced technology, high rates of capital formation and colossal supplies of underemployed labour. The US has a high rate of productivity growth and highly stretched consumers. Japan has suffered from years of deflation. For these reasons, the stimulus needed is enormous and the inflationary pressure that results is minimal.

Second, the US wants a currency depreciation, to keep as much of this stimulus as possible at home. Blocked by the actions of members of the dollar-zone currencies, it is all the more important for it to enjoy a depreciation against significant currencies outside the zone. The monetary policy the Fed is pursuing naturally generates that result.

Third, dollar short- and long-term interest rates remain much lower than one might normally expect. Short-term interest rates are low to generate the needed stimulus. But interest rates are also kept down by the reserve accumulations of dollar-zone central banks. At the end of last year, more than two-fifths of US Treasuries were held by the Fed or foreign official sources. This year, buying of US Treasuries by foreign official sources may reach another $750bn. The impact, argues the paper, is to keep real interest rates up to a percentage point below their historic norm.

Fourth, dollar-zone central banks cannot diversify out of the dollar and into, say, the euro without undermining their dollar peg. If they purchase euros, they must intervene to avoid an appreciation against the dollar. This will, again, support the dollar and the prices of US Treasury securities. But should they go ahead with diversification, upward pressure on the euro might become intolerable for the eurozone members, though be of little concern to anybody else.

Finally, it is perfectly possible for the foreign central banks to continue to buck the market indefinitely. The view that the market can always defeat central banks is half true and half utterly mistaken. It is impossible for a central bank to defend a currency that the market wishes to sell, but simple to defend one the market wishes to buy, provided it does not care about (or can manage) the monetary consequences. The Bank of Japan and the People's Bank of China can create infinite quantities of yen or renminbi should they wish to do so. At present, they do.

How might this saga end? To answer the question, we need to examine the motives of the participants: the US is able to enjoy low real interest rates and a large excess of spending over income; members of the dollar zone achieve more stable growth by subsidising manufactured exports and minimising vulnerability to volatile capital flows. The US might attack the policies of its dollar-zone partners if the administration found the political drawbacks of trade deficits greater than the advantages of low interest rates. Its partners might change their policies if they found the dangers of overheating, or US protectionism, greater than the advantages of competitive exchange rates.

In the meantime, as the more recent of the papers concludes, "the unwillingness to accept the inevitable downward slide in the US dollar, due to a massive labour surplus in much of Asia and cyclical fears in Japan, is leading to intervention flows that are unprecedented . . . We are experiencing an official sector effort to reverse global private capital flows on a scale that we have never seen, even at the end of Bretton Woods."

The Bretton Woods system was broken by US protection against imports and worldwide inflation. Either could recur. But timing is unpredictable. Meanwhile, efforts to expand the US economy are driving a global boom. Enjoy!

** An Essay on the Revised Bretton Woods System, Working Paper 9971, September 2003, www.nber.org;*
*** The Revised Bretton Woods System: The Effects of Periphery Intervention and Reserve Management on Interest Rates and Exchange Rates in Center Countries, Working Paper 10332, March 2004, www.nber.org*

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