The Holy Grail of Central Banking
by Joergen Oerstroem Moeller

06.06.2007

When the G-8 leaders meet this week they can congratulate themselves on high global growth, low inflation and a stable international monetary system. A similar picture has not been seen since the economic globalization of pre-1914 vintage. The current inclination is to credit central bankers, not political leaders, for these successes. The impression is that monetary policy is in the hands of the proper people, who possess the confidence necessary to steer a course round the rocks that shipwrecked predecessors. A golden age of central banking has arrived.

It is true that the central bankers' scoreboard looks impressive. Since 1993, the world has not experienced one single global monetary crisis on par with the turmoil of the 1970s and 1980s. Recent crises—in Asia in 1997 and 1998, in Mexico in 1994 and in Argentina in 2000—have all been regional. These, with the possible exception of the 1998 Russian financial crisis, did not profoundly destabilize global financial markets. At the same time, the world has moved from comparatively high inflation rates in the 1980s into a bracket of 2 to 3 percent for most industrialized countries. Wage increases have been kept in check, despite persistent high economic growth.

The switch to inflation targeting as the central bankers' main policy objective is normally singled out to explain why the impossible—high economic growth and low inflation—suddenly has become possible.

In fact, central bank policies have had very little to do with producing such a string of splendid economic figures. In a recent **interview**, former Chairman of the Federal Reserve Alan Greenspan admitted that "the prevalence of low interest rates throughout the world was one of the things that surprised him."

Indeed, the world economy owes its current vitality to the emergence of China and other low-cost producers. These countries offer manufactured goods at low prices and welcome outsourcing. The direct effect is lower costs, which is multiplied by the indirect downward pressure on industrialized countries' domestic wages. In these circumstances, the central banks' tweaking of interest rates and money supply has been—albeit not irrelevant and not without policy impact—much less powerful and much less necessary than it was before the early 1990s.

As China and comparable countries have built up production capacity to meet strongly increasing demand, the boom in private consumption in the United States has not led to what conventional economic theory predicts: a rise in prices. Instead, low-cost production in the developing world has kept inflation in the developed world in check. This unexpected price stability—and in some cases, falling prices—has created a consumer’s paradise, encouraging consumers to spend even more on goods and services.

Since a rise in consumer demand has not been accompanied by an increase in the inflation rate, central bankers believe that there is no reason to put the brakes on consumer spending—regardless of growth, employment and balance of payments. Inflation targeting means that as long as the inflation rate is kept at around 2 percent, everything is fine, and all other traditional economic warning signals should be disregarded. Consequently, monetary policy has not been adjusted, and central banks continue to stimulate their respective economies with loose, liquidity-creating monetary policy. Only recently and half-heartedly have central bankers around the world tightened up monetary policy—but not by very much.

The economy is a complex machine, so the excess liquidity pumped into the system by central banks has to go somewhere. That "somewhere", as of late, has been assets: stocks, bonds, gold, property. As liquidity flows into these assets, asset prices rise out of proportion to the actual value of the assets, creating speculative bubbles.

The very central bankers whose monetary policies create these bubbles have enhanced their reputations by warning against the potential negative effects of such bubbles—as was the case in 1996, when Alan Greenspan spoke about the stock market’s "irrational exuberance."

Fortunately for central bankers, the foundation that supports their inflation-targeting strategies—the ability of low-cost producers to meet demand without increasing producer prices—appears to be in no danger of collapse. The number of people in the working age in China will continue to rise for a decade and in India, even longer. Information and communications technology has been coming to these countries, bringing with it a jump in overall productivity.

For now, protectionism in the United States and Europe represents the principal threat to the inflation-targeting strategies of central bankers. If protectionists succeed in setting up obstacles to imports from countries like China and India, inflation rates in Europe and the United States will certainly increase, causing confidence in central banks to fall.

Worse, this chain of events will eventually lead to the popping of asset bubbles, generating a possibly severe economic downturn. For the first time in 15 years, central banks will see inflation-targeting strategies jeopardized.

Alternatively, financial systems could become complacent and start lending to excessively risky borrowers because other assets have become too pricey, and thus out of reach. Non-performing loans may gobble up an increasing share of asset portfolios, threatening systemic stability in the case of loan defaults.

The recent troubles of the subprime-mortgage market in the United States are a perfect illustration of this problem. When large numbers of subprime—that is, risky—borrowers proved incapable of paying off their mortgages, several subprime-lending institutions collapsed. Some experts have predicted that the implosion of the subprime-mortgage market will eventually prompt an economy-wide recession in the United States.

While the goal of containing inflation is commendable, central banks' inflation-targeting strategies can stoke asset price increases, thereby destabilizing the economy. Perhaps central banks should supplement their inflation-targeting strategies with an asset-price yardstick. After all, the principal challenges to economic stability over the last 15 years have been asset bubbles, not inflation.

Joergen Oerstroem Moeller is visiting senior research fellow at the Institute of Southeast Asian Studies, Singapore and an adjunct professor at Copenhagen Business School. The views expressed are his own.

P: (800) 893-8944, Outside the U.S.: (914) 962-6297 | backissues@nationalinterest.org
P.O. Box 622 Shrub Oak NY 10588

The National Interest is published by The Nixon Center

The Nixon Center
1615 L Street, Suite 1250
Washington, DC 20036
www.nixoncenter.org