Sense, Nonsense, and International Monetary Reform

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Robert Zeollick, the president of the World Bank, is clearly seeking to draw more attention to his ideas. In September, in advance of the World Bank/IMF meetings, he made a major speech on rethinking development policy, whose main message seemed to be "let a thousand flowers bloom." Now, coincident with the G20 summit in Seoul, he has called for reform of the international monetary system to include a role for gold.

Hair-brained schemes are certainly one way of drawing attention to one's ideas. To be sure, Zeollick is not very specific about what he means. Contrary to much of press coverage of his talk, he does not come out and explicitly call for to a return to the gold standard.

But how else should one interpret the statement that "The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values." Zoellick may not want central banks to be legally bound to peg the domestic-currency price of gold. But what is the preceding if not a recommendation that central banks react to gold-price movements?

One wonders whether the World Bank president has contemplated the implications of his advice. At the moment, gold prices are high and rising. Under the Zeollick rule, the Fed, Bank of England, ECB and Bank of Japan would have to tighten sharply in order to bring them back down. One can question, as many people have, whether the Fed's new round of quantitative easing is advisable, and whether it will work. My own view is that QE2 should be thought of as a down-payment on an insurance policy against the U.S. economy lapsing into deflation – and on those grounds is a risk worth taking. But it is lunacy to suggest that, in circumstances of weak growth and deflation risk, key central banks should simultaneously tighten. And this lunacy is precisely the implication of Zoellick's idea.

This is a measure of the difficulty even serious people have in thinking about how to effectively reform the international monetary system.

To be fair, Zeollick's other observations about the future of the system are sensible enough. He observes, correctly, that the international monetary system that is coming will involve multiple reserve currencies. Put another way, it will be less dollar-dominated.

He then suggests that, along with the dollar and the euro, the pound sterling and the Japanese yen will remain consequential reserve currencies. And he suggests that they will be joined by the Chinese renminbi once China liberalizes its controls on capital inflows and outflows. One can question Zeollick's confidence in sterling and the yen. Neither currency plays a consequential international role today. And given Britain's small size and Japan's gloomy demographic prospects, it is hard to see why they should play more consequential roles tomorrow.

But in pointing to the emergence of the renminbi as a prospective international and reserve currency, Zeollick is on firmer ground. Chinese officials are already actively encouraging their neighbors and more far-flung countries, including in Latin America, to invoice and settle their China trade in renminbi. They are encouraging banks and corporations to float renminbi-denominated bonds in Hong Kong. They have allowed foreign corporations like McDonalds to issue renminbi bonds in Shanghai to fund their investments in China. Full capital account liberalization may be years off, but the direction is clear.

This system of multiple international currencies would be an improvement over the dollar-dominated status quo. No one country would have a monopoly over providing international reserves. No single country would be able to abuse this exorbitant privilege in the manner of the United States in the years leading up to 2007. Countries seeking international reserves that are both liquid and will retain their value will have several places to turn. This discipline will, in turn, prevent any of the reserve-providing countries from abusing their special status.

Why then recommend an ancillary role for gold? It's not as if central banks need the gold prices to remind them that inflation or deflation is happening. Movements in headline or consumer price inflation more than suffice. What they need is the will to act. Advanced-country central banks facing the specter of deflation need to move against it more forcefully – here I include even the Fed. Central banks in emerging markets where the problem is inflation have been responding appropriately by tightening, but they should have begun moving earlier.

The other reason why commentators like Zeollick suggest a role for gold is, presumably, their discomfort with the volatility of exchange rates. Evidently they believe that by restoring a monetary role of gold the exchange rate stability that prevailed under the 19th century gold standard would magically return.

It wouldn't be, of course. Central banks and governments would never commit to pegging the domestic-price of gold, which is what is required for pegged exchange rates. And even if they did, any such commitment would be abandoned the first time unemployment began to rise. Anticipating this, speculators would launch an attack on the pegged gold price in advance of the fact. The whole system would quickly become an engine of instability.

Is there another way of enhancing the stability of exchange rates? Not really. So long as economic conditions continue to differ between advanced and emerging markets, appropriate monetary policies will differ. And if monetary policies differ, exchange rates will have to adjust.

That's what we are seeing at the moment. The problem is that emerging markets are uncomfortable about how quickly that adjustment is taking place. Such are the fruits of waiting too long to start.

In contrast, it should be possible to damp down short-term currency volatility. Research shows that short-term fluctuations between two currencies are less when their respective central banks both formally adopt inflation targeting. A formal inflation target makes it easier for investors to forecast price movements. And if price movements are more easily anticipated, so are exchange rates, which then tend to settle down.

Thus if central banks that have not yet formally adopted inflation targeting, starting with the Fed and the People's Bank of China, do so, we could worry less about short-term exchange-rate volatility. And if central banks did not attempt to suppress the longer-term adjustments in currency values needed to rebalance the world economy, those inevitable adjustments, when finally allowed to start, would not occur with disconcerting speed. This would not be a perfect international monetary system. But it would be an improvement over the one we have now.

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