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The coming battles over monetary policy

As the world recovers from the Great Recession, get ready for some new fireworks, of a sort we haven't seen for a while – over monetary policy. Just about every other weapon in the government economic-policy arsenal has been discarded, or denied; monetary policy is what remains. And that means that the political pressures that are typically exerted elsewhere are likely all to concentrate on the world's monetary authorities. To see how and why this happened, we have to go back to the 1970s.

The Bretton Woods international monetary system, adopted after World War Two, provided 25 years of monetary stability and economic growth. The system was not up to the challenges of the late 1960s, and collapsed in 1971. In the wake of the end of this modified gold standard, inflation soared almost everywhere. In a turbulent decade, marked by oil price hikes, deep recessions, and high unemployment, many governments used active monetary policies to stimulate the domestic economy, and consistent attempts to weaken currencies to promote international competitiveness.

However, governments soon realized that while slow growth was unpopular, inflation was no political or economic remedy. Over the course of the 1980s and early 1990s, a new monetary consensus emerged. Politicians resolved to give priority to keeping prices stable and inflation low, even if it meant giving up a traditional tool of macroeconomic policy. They did so in many ways. Some made their central banks much more independent, appointed monetary conservatives to run them, and stood by as the central bankers pledged themselves to very low inflation targets. Others tied their currencies to those of traditional low-inflation countries. Still others – such as those in the European Union – resolved to give up their independent currencies and band together in a monetary union committed to low inflation. One way or another, from Washington and Frankfurt to Brasilia and New Delhi, governments effectively gave up active monetary policies as an everyday tool of economic policy.

The result was what eventually came to be known as the Great Moderation, nearly twenty years of stable prices and uneventful monetary policy. But just because governments let go of the reins of monetary policy, they did not give up trying to affect the economy. Their constituents were hardly going to stop demanding action just because governments were bound to keep inflation low.

Most governments dealt with the loss of some or all of their monetary room to maneuver by increasing their use of active fiscal policy. Starting in the early 1990s, government budget deficits grew almost continually – aided by the enormous, efficient global financial system. Prices remained stable, but deficits grew at a pace rarely seen.

The Great Recession that began in 2007 brought an end to the days of unlimited deficit finance. Many of the governments that had had easy access to international capital markets were suddenly frozen out, or forced to pay prohibitive rates to borrow. Among those countries that remained credit-worthy, such as the United States, the public's appetite for budget deficits seemed distinctly reduced. Recession-driven cyclical deficits persisted, but there is little expectation that we will return to the days when governments could run deficits with abandon, and anticipate that they would be financed at low cost. Just as difficulties with active monetary policy in the 1970s pushed it into the background in the 1980s, today's problems with deficit financing will certainly reduce the room for governments to use active fiscal policy in the near future.

Meanwhile, monetary policy has roared back into view as the principal – perhaps the *only* – real tool available to governments facing the worst crisis since the 1930s. In Europe and the United States, in fact, the ECB and the Fed were pretty much the only games in their respective towns. Their quick, decisive, and massive intervention in financial markets staved off a collapse that could have been more severe than the Great Depression. Because recovery has been so slow, indeed, major central banks have continued to bear the brunt of softening the adjustment to a new economic reality. Monetary policy in the major centers has come to include large-scale purchases of all sorts of assets – something that comes close to the effects of traditional fiscal policy. In smaller developed, and many developing, countries, this has included exchange-rate policies to improve the competitive position of national producers. This turns out to be a lot more effective than conventional trade protection – which in any case risks retaliation from fellow WTO members.

But in economic policy as in the economy, there is no free lunch. As the weight of economic policymaking falls more and more heavily upon monetary policy, we can expect that it will attract ever keener attention from potential winners and losers. Just as policymakers have rediscovered monetary policy, so too will politicians and the public. And there will be plenty of disagreements over how it should be handled.

Ron Paul and his allies have been taking the Fed to task for several years, but their criticisms have not penetrated the mainstream. However, as the Fed continues to keep interest rates at historic lows, its actions will become ever more controversial. People who rely on their savings for their income – especially the elderly – have already been squeezed. After years, even decades, in which they could expect annual real rates of return in the 4-6 percent range, they now must settle for one or two percent, if that. This can mean the difference between a comfortable lifestyle and real personal hardship.

The relatively apolitical nature of monetary policy in recent years – especially during the Great Moderation – is in fact an aberration. Monetary and currency policies have long been controversial. Throughout the nineteenth and early twentieth centuries, "The Money Question" was a central issue in American policies – from controversies over the First and Second Banks of the United States to the Populist assault on the cross of gold, to Roosevelt taking the country off the gold standard in 1933. Similar political battles were common in Europe and Latin America.

More recently, the creation of the euro brought monetary and currency policies back into the center of European politics, and recurring currency and banking crises did the same in many developing countries. The crisis that erupted in 2007 created monetary strains throughout the Eurozone. It also fueled tensions among countries, as witnessed by prominent talk by Brazilian and Russian leaders of "currency wars."

What are the line-ups we can expect in the coming monetary battles? The most basic is between debtors and savers – or, more accurately, net debtors and net creditors. Those with nominal debts gain with low interest rates and higher inflation, as this reduces the real burden of their obligations. On the other hand, savers lose income with low interest rates, and lose capital with inflation. This helps explain why a high-savings country like Germany is so adamantly anti-inflation. But it also helps explain why, in the United States, the Fed's zero-interest rate policies have been particularly unpopular with one of the Republican Party's principal bases of support, people over 55 who rely, or intend to rely, in large part on their own savings for retirement. Another group of those in the strong anti-inflationary camp are those on fixed incomes, or on incomes that they expect to rise more slowly than inflation.

Monetary policy also implicates the exchange rate, and this too divides the population. The looser the monetary policy, the weaker the currency – a welcome development for producers who face foreign competition in domestic or overseas markets. But a weaker currency also diminishes purchasing power, reducing the ability of nationals to buy the goods, services, and assets of others. And for those whose debts are in foreign currencies, a weaker currency means a heavier debt burden.

Monetary policy is likely to be the source of conflict among countries, too. National monetary policies spill into the international arena as they affect exchange rates. And with most of the world's troubled economies eager to stimulate output, governments have strong incentives to make or keep their currencies weak. Of course, not all currencies can depreciate, and the race to gain competitive advantage by way of currency policy is fraught with danger. In fact, "competitive devaluations" were central to the international economic battles of the 1930s. Were currency wars to break out today, they could implicate international trade and investment, as well as threatening cooperation among the major financial centers.

For most of the past twenty years, monetary policy has been largely de-politicized. Central banks have acted independently, monetary autonomy has been surrendered to currency pegs or dollarization, new supranational currencies have been created. Government found other avenues in their attempst to satisfy the demands of their constituents. Now many of those avenues, especially those involving government spending and borrowing, are closed off. Monetary policy will come back toward the central of national and international politics.