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Insight: Economic malaise fuels global monetary order debate

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By Alan Wheatley, Global Economics Correspondent

LONDON (Reuters) - Put money supply growth on auto pilot. Make financial stability an explicit goal of central banking. Set up a European Monetary Fund. Create a new global currency anchor by pegging the yuan to a basket of commodities.

A flurry of proposals from economists, coinciding with a semi-annual IMF gathering in Washington, reflects more than a passing loss of confidence in policymakers' ability to get to grips with the intractable financial crisis that began in 2007.

It also speaks to a growing sense, among politicians as well as market practitioners, of the limits of central banks' power and a belief in some quarters that the very foundations of the global monetary order need to be rebuilt.

The crunch with its roots in a U.S. housing bubble is the latest in a depressingly regular succession of crises since the severing of the dollar's link to gold in 1971 doomed the Bretton Woods regime of fixed-but-adjustable exchange rates.

Latin American debt and U.S. savings and loan banks in the 1980s; dollar-linked Asian economies and hedge fund LTCM in the 1990s; and the dot.com bubble at the start of the millennium.

What links all these episodes is the mistaken belief that ever more credit can soothe any economic pain, said Leigh Skene, an economist with Lombard Street Research, a London consultancy.

U.S. debt as a percentage of gross domestic product started to rise in a straight line in the 1970s and, despite a recent dip as over-extended households pay off loans, remains 2.5 times higher than its World War Two peak.

"Continued financial crises are guaranteed until balance sheets are repaired," Skene said this week at a presentation for investors.

According to this line of thought, Alan Greenspan and his successor as Federal Reserve chairman, Ben Bernanke, are guilty of delaying the needed purging of credit-induced excesses in the economy by cutting interest rates every time growth turned down -- the so-called "Bernanke put" in market jargon.

Yet the Fed seems to be running into the law of diminishing returns. The boost to growth and confidence from the second volley of asset purchases the U.S. central bank unleashed a year ago lasted just a few months. Its plan announced on Wednesday to revive U.S. growth by buying more longer-dated bonds triggered a sharp sell-off in global stock markets.

Dominic Wilson, director of global macro and markets research at Goldman Sachs in New York, said investors might have been discouraged by the Fed's accompanying gloomy assessment of the economy.

"But the darker possibility is that markets are becoming more worried about the capacity of policy to affect the outlook," Wilson said in a note to clients.

OUT OF CONTROL

Seen in that light, restoring confidence might require much more than the well-identified immediate actions that markets are demanding: among them, extra capital for Europe's banks, the underwriting of weak euro zone members' debts and a clear path to medium-term debt reduction in the United States.

For Thomas Mayer, Deutsche Bank's chief European economist, the unfolding of the latest crisis has seen the unbearable burden of debt shift from weaker to stronger shoulders -- from the sub-prime mortgage sector to the money markets, the banking sector and, more recently, to the public sector.

"But in this process the previously strong shoulders have also been weakened. Somehow the old tricks seem to have lost their magic, and the crisis triggered by massive de-leveraging appears to be getting out of control," Mayer wrote in a report.

The International Monetary Fund weighed in on Wednesday with a warning that plentiful cheap credit, though necessary for now, could end up doing more harm than good in the long run by undermining financial stability.

Mayer worries that the desperate attempt to avoid an economic slump brought on by the needed paydown of debt could eventually lead to a crisis of the fiat money system itself -- that is, a system backed only by faith in governments -- as central banks print money to buy up outstanding debt.

If fiat money fails, it may well be replaced by money backed by real assets that cannot be augmented at the stroke of a pen of central bankers, Mayer said.

"How could this happen? One possibility -- which at present may sound a bit like science fiction -- would be for China and other big emerging market countries to peg the value of their currencies to a basket of commodities.

"It would then be up to the industrial countries to try to stabilize their currencies against the yuan, or accept the inflation that goes along with secular depreciation," he said.

A ROLE FOR CHINA

Science fiction or not, Dean Baker, co-founder of the Center for Economic and Policy Research in Washington, said the current global monetary order clearly does not work; the dollar could lose its dominant status within a decade.

"The big determining factors will be the extent to which the euro zone countries repair their system and the extent to which China wants its currency to become an international currency," Baker said.

The idea that a bigger role for the yuan can help steady the global monetary order has become an article of faith.

China has been a destabilizing force, critics say, by holding down the yuan. This has generated huge external surpluses that have driven global interest rates below their natural rate and so contributed to speculative excesses.

French President Nicolas Sarkozy and U.S. President Barack Obama agreed on Wednesday on the desirability of adding the yuan to the basket of currencies that make up the Special Drawing Right (SDR), the IMF's in-house unit of account.

The untested theory is that China would pursue policies deemed more conducive to global stability, such as letting its exchange rate rise and opening its capital account, if it was given more responsibility.

Some policymakers would like a broad-based SDR to evolve into a global reserve currency, but a recent paper from the Center for Economic Policy Research in London argues that greater use of SDRs would not, by itself, cure the structural efficiencies of the international monetary system.

Economics professors Emmanual Farhi of Harvard University, Pierre-Oliver Gourinchas of the University of California, Berkeley, and Hlne Rey of the London Business School instead recommend ways to temper crises by making international liquidity more plentiful.

They advocate issuing mutually guaranteed European bonds; making temporary central bank swaps permanent; expanding IMF credit facilities and funding mechanisms; and creating a mechanism at the IMF to pool foreign-exchange reserves.

NO MORE BUSINESS AS USUAL

The Committee on International Economic and Policy Reform, a non-partisan group of academics and former government and central bank officials, argues that the lesson from the crisis is that business as usual is impossible.

"There is now increasing recognition that the conventional approach to central banking needs to be rethought," said Eswar Prasad, a trade and economics professor at Cornell University and a member of the committee. "Central banks should go beyond their traditional emphasis on low inflation to adopt an explicit goal of financial stability."

Not everyone agrees that a radical overhaul is needed. Uri Dadush with the Carnegie Endowment for International Peace in Washington reckons the global monetary system has performed well during a tumultuous time.

"The rules of the game do not need a big change; rather the big players need to raise their game. Until they do, no conceivable reform of the rules can provide stability," Dadush and others wrote in a recent report.

Think-tanks are paid to think. What is significant is that the debate over whether central banks should take the blame for blowing credit bubbles and perpetuating global economic imbalances is no longer confined to academia.

In Germany, the Netherlands and Finland, political parties are deeply divided over how far the European Central Bank and euro zone governments should pursue unconventional policies to tackle the bloc's debt crisis.

In the United States, Texas Governor Rick Perry courted controversy within days of entering the race to be Republican candidate in the 2012 presidential election by issuing a blunt warning to Bernanke.

"Printing more money to play politics at this particular time in American history is almost treacherous, treasonous in my opinion," he said in Iowa on August 16.

Another Republican candidate, Mitt Romney, has declared the central bank's easy money policies to have failed and top Republican congressional leaders took the highly unusual step of writing to Bernanke ahead of this week's Fed policy meeting to urge it to resist further economic interventions.

This is music to the ears of monetarists such as Brendan Brown, who in a new book, "The Global Curse of the Federal Reserve," advocates stripping the central bank of its power to create money.

Brown, an economist at Mitsubishi UFJ Securities International in London, criticizes the Fed for having presided over a century of U.S. monetary disorders across the globe, culminating in Bernanke's planting of monetary "timebombs" when he launched two rounds of quantitative easing, or asset purchases with new money.

Big changes to the monetary order happen infrequently, but Brown reckons the political momentum in the United States is such that global markets should be pricing in just that possibility in 2013.

"If the second monetarist revolution comes anywhere, it's going to come in the U.S., and it's only going to be led by the political process. You're never going to get it led from people in the central bank," he said in an interview.

(Additional reporting by Herb Lash in New York, editing by Mike Peacock)