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Managing Globalization:Bretton Woods, reversed

By Daniel Altman
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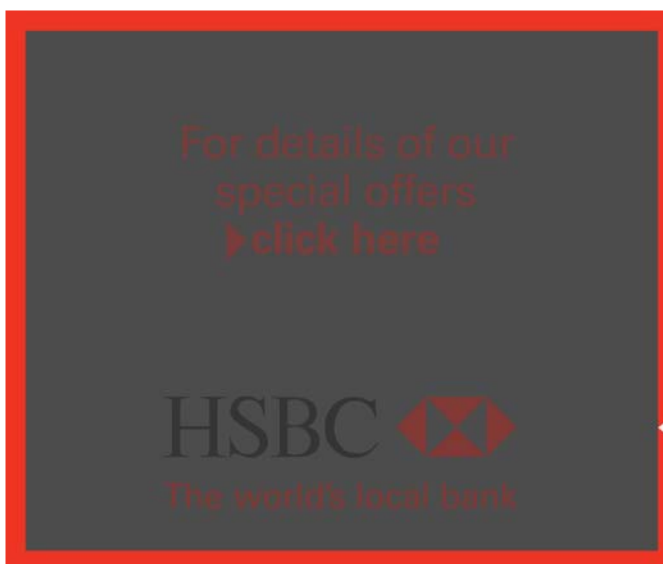
Globalization has brought the world a host of very tangible challenges, ranging from adapting products to compete in international markets to retraining for new jobs. But every nation faces an additional task, whose rigors may not always be as vivid or obvious: developing a stable monetary policy. Now, a professor based in the United States has asserted that this problem may have an almost universal solution.



Andrew Rose, an economist at the University of California at Berkeley, has concluded that one set of policies stands head and shoulders above the rest. A combination of floating exchange rates and inflation-targeting is a recipe not just for a stable policy within a country, he writes, but also for a stable global monetary system.

This month the National Bureau of Economic Research published his working paper, "A Stable International Monetary System Emerges: Inflation Targeting is Bretton Woods, Reversed." The Bretton Woods system was set up during World War II as a means of maintaining stability in international financial markets. It required the major economies of the world to link their currencies at fixed rates to the dollar, which was in turn linked to gold, with the International Monetary Fund acting as a sort of referee and trouble-shooter. As the United States moved toward floating exchange rates, the system was gradually dropped in the early 1970s.

Rose argues that the disaggregated, decentralized "system" composed of inflation-targeting countries is just as stable as Bretton Woods was in its heyday, if not more so. It's an idea that's bound to attract market-oriented economists: the set of independently chosen monetary policies in many national economies can be superior to a centrally planned system.

When governments choose a monetary policy, they're deciding their goals for the size of the money supply, interest rates and exchange rates. The three items interact, of course, and together they help to determine a country's position in international trade and foreign investment.

Let the money supply to expand too quickly and you'll put downward pressure on your exchange rate. If you try to fix your exchange rate too high, you could face low demand for exports and falling rates of return at home. Push interest rates too low, and foreigners may not want to invest in your markets.

Around the world, central banks aim for levels of the money supply, interest rates, inflation rates, unemployment rates, economic growth rates or any combination of the above. The U.S. Federal Reserve has no fixed targets, though its mandate is to control inflation and set the right conditions for economic growth. The Bank of Canada must contain inflation within a narrow band, now at 1 percent to 3 percent per year, with a target of 2 percent. In Japan, the focus is on maintaining the economy's fragile recovery from a decade-long slump, by hook or by crook.

Exchange-rate regimes are just as numerous. Some governments link their money's value to a weighted average of the most commonly traded currencies; China does so with the dollar, the pound, the euro, the yen and several others. Quite a few peg their currencies firmly to the currency in a bigger

or neighboring country; for years, Saudi Arabia has pegged its riyal at 3.75 to the dollar. And an increasing number of countries simply allow their currencies to float freely on international markets.

Rose shows that no country with both inflation-targeting and floating exchange rates has ever had to abandon the system. By contrast, countries with different systems tend to change their policies every three to six years. In that sense, the policy combination is domestically stable. But why is it a stable international system, too?

In statistical comparisons of inflation-targeting countries and a control group, Rose finds some evidence that the former experience significantly smaller fluctuations in exchange rates over long periods of times. He also shows that there are markedly fewer big swings in the flows of foreign money into countries that use inflation targeting. And he points out that there's no need to give a central role to the dollar, gold or the IMF.

Rose leaves one question unanswered, though: Does a country need to be financially stable already in order to adopt the model system? Looking over his list of inflation-targeting countries, you can see quite a few veterans of troubled times: Mexico, Thailand, Brazil and Poland are among them. Yet most of these countries waited until a few years after their financial crises to implement the favored policies.

So, for distressed countries seeking financial stability, a decision to adopt the floating-rate, inflation-targeting mix may come with high hopes, but it will still require a modicum of faith.

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