Central banks in the rich world no longer determine global monetary conditions

EXACTLY 30 years ago, in August 1977, The Economist published an article by Alan Greenspan, the former chairman of America's Federal Reserve, who was then a private-sector economist. It listed five economic "don'ts". One of these was: "Don't allow money-supply growth to spiral out of hand." Yet that is exactly what central bankers have done in recent years. The bubble in credit markets that now seems to be bursting and the frothiness of so many asset prices was encouraged by loose monetary policies which pumped liquidity into financial markets.

Many economists blame that excess liquidity on Mr Greenspan himself for keeping interest rates too low for too long when he headed the Fed. After the dotcom bubble burst in 2000-01, the Fed slashed short-term interest rates to 1% by 2003. The European Central Bank (ECB) and the Bank of Japan also cut rates to unusually low levels, pushing the average interest rate in the big rich economies to a record low. The real short-term interest rate is now above its long-term average for the first time since 2001, suggesting that global monetary policy is no longer loose. So why did financial markets remain exuberant for so long? One reason is that the world's two most important central banks, the Fed and the ECB, have not been the main sources of global monetary liquidity.

Many economists in investment banks and international institutions mistakenly assume that "global" monetary conditions are set by the central banks of the rich economies. Yet over the past year, a staggering three-fifths of the world's broad money-supply growth has flowed from emerging economies.

Their mints are working overtime. Goldman Sachs reckons that growth in China's M3 measure of broad money has quickened to 20% over the past year. In Russia money supply has grown by a striking 51% and India's is up by 24%. Indeed, the broad money supply in emerging countries has increased by an average of 21% over the past year, almost three times as fast as it has in the developed world. Adjusted for inflation, their money growth has accelerated alarmingly (see chart). As a result, the entire world's money supply is growing at its fastest for decades in real terms.

One would expect emerging economies' money supply to outpace that of the rich world, because their GDP growth is faster. But their surplus money growth over and above the increase in nominal GDP (a crude measure of the excess money available to be invested in financial assets) is also far bigger. Their interest policy has been timid: over the past three years, as monetary policy has been tightened in America and the euro area, average rates in the emerging world have barely budged. China and India have real interest rates among the world's lowest, even though they have the fastest-growing economies.

A decade or so ago, speedy monetary growth in emerging economies was of little concern to the central banks of the developed world: a monetary deluge in Brazil, say, simply caused hyperinflation there. But today these economies play a larger role in the world economy and cross-border financial flows are much bigger. Inflation remains low, so the liquidity pumped out by central banks is flowing somewhere else, namely into global financial markets. For instance, huge purchases of Treasury bonds by these central banks have reduced bond yields, and so spurred excessive borrowing in America.

The policies of the People's Bank of China (PBOC) or the Bank of Russia are likely to have an increasing impact on developed economies in future as capital controls are reduced and markets become more integrated. This prospect becomes more alarming when one considers that, unlike the Fed and the ECB, most central banks in emerging economies are not independent, and thus free to set interest rates in the best long-term interest of the economy. They are still firmly under the thumb of politicians.

Yes, Minister
According to conventional wisdom, monetary-policy mistakes such as those that caused the Great Inflation in the 1970s are much less likely today because central banks in the rich world are now independent of politicians. Yet few of the main central banks in emerging economies enjoy full legal independence, and thus often face pressure from politicians to hold interest rates low to boost growth and jobs. Their monetary independence is also constrained by governments’ desire to hold down exchange rates. This forces central banks to engage in heavy foreign-exchange intervention, which inflates money supplies.

A recent IMF study ranked 163 central banks according to their political autonomy (based on factors such as how officials are appointed, the length of their terms and whether interest rates have to be approved by the government). Emerging central banks have become more independent since the 1980s, but they remain much less so than the ECB or the Fed. Some of the central banks that have been pumping out the most money, notably those in China, India and Russia, are among the least independent. The PBOC is under the sway of the Communist Party. The Reserve Bank of India would have raised interest rates more aggressively last year were it not for political pressure. Controversially, the study reckons that both central banks are more independent than the Bank of Japan—another country where its own cheap money policy has created a flood of liquidity outside its borders, through the carry trade.

The days when central-bank watchers could just focus on the Fed and perhaps the ECB in order to assess “global” monetary conditions are over. They no longer control the amount of money sloshing around the world and, as financial markets become ever more linked, analysts will need to pay more attention to central banks in the emerging world. They may even have a bigger role to play in stabilising the global economy if the squeeze in the credit markets becomes more acute.