LAST week the Financial Times reported on anger within the French political establishment over America's abuse of its "exorbitant privilege" as issuer of the world's global reserve currency. Because of the dollar's overwhelming ubiquity in the global economy it is preferred for all sorts of transactions—including the ones in violation of American sanctions that were orchestrated by BNP Paribas, a French bank. As those transactions used dollars, they were ultimately cleared through New York. That, in turn, gave American officials the authority to punish BNP, which they used, socking the bank with a fine of almost $9 billion. The French seethed:

We [Europeans] are selling to ourselves in dollars, for instance when we sell planes. Is that necessary? I don’t think so. I think a rebalancing is possible and necessary, not just regarding the euro but also for the big currencies of the emerging countries, which account for more and more of global trade.

The very next day, the Financial Times ran another story, which also featured dispeptic French leaders. This time, the irritant was the dear euro:

“[Europe] cannot be the only economic zone of the world that doesn’t consider its currency as a weapon . . . as a key asset to promote its economy,” [Airbus CEO Fabrice Brégier] told the Financial Times in an interview.

Mr Brégier’s comments coincide with calls from the International Monetary Fund and politicians in some eurozone countries – France in particular – for the bank to consider a programme of quantitative easing to tackle low inflation, sluggish economic growth...
and the strong euro.

The juxtaposition is more than an occasion to chuckle at French hypocrisy. In fact, it illustrates tensions brewing within the global monetary system. America has the ability to use its currency as an instrument of foreign policy. But the dollar's status as a reserve currency means that the dollar has a value over and above its utility in buying American goods. The dollar is therefore more expensive than it might otherwise be, which is a source of constant irritation to American exporters. It also constrains American policy. The world cares a great deal when its regulators punish violations of American law or when its central bank tries to stimulate a sagging American economy. American leaders are therefore forced either to limit such actions or to accept a cost to their soft power when they go ahead despite foreign complaints.

Were the euro to play more of a global role, as was once thought likely and as the French occasionally desire, these trade-offs would become more acute for European policy makers. The same would be true in Beijing, as well, if China were to succeed in establishing the renminbi as a reserve currency.

In the issue of July 5th, we ran a piece giving a (brief) history of the global monetary system, which noted:

Global commerce has long faced a fundamental tension: the more certainty countries create around exchange rates, the less room they have to manage domestic economic affairs. Thirty years before Bretton Woods a war wrecked the world's first stab at the problem—the gold standard—and the attempt to rebuild it in the 1920s led to depression and another war. The exchange-rate system agreed at Bretton Woods lasted only a generation. After 150 years of experimentation the world has yet to solve its monetary problem.

Economists often refer to the monetary trilemma, which has it that an economy can have at most two of: open capital flows, a fixed exchange rate, and an independent domestic monetary policy. Put differently, if one takes free movement of capital as given, then one can either prioritise exchange-rate stability or domestic imperatives. The greater the emphasis on one the less control there is over the other.

Its tempting to argue that this hardly matters now, since the day of fixed exchange rates is long gone. The rich world's efforts to rebuild the gold standard after the first world war, and then again via Bretton Woods after the second both fell apart. Any lingering taste for fixed exchange rates was then extinguished in the crises of the 1990s.

But that's not actually right. Even when currencies float against each other, as the euro and dollar do now, valuations are extraordinarily sensitive matters, as the French anxiety in the piece quoted
above indicates. And floating is much more rare than people commonly imagine. Less than 10% of emerging market economies allow their currency to float freely; more than a third have a rigid peg. The currency of the world’s second largest economy is heavily managed against that of the first; China and America function at times like a massive single currency area. Meanwhile, many of the world’s other large economies are linked up in a true single-currency area; the euro zone is like the gold standard only more so.

In past monetary regimes, exchange-rate stability was considered desirable as a means to boost trade. It reduced transaction costs, of course, but it also kept major economies from using their exchange rate as a weapon of mercantilism. But as our recent piece notes, fixed-rate systems are only sustainable, and only continue to boost trade, while domestic politics support prioritisation of exchange-rate stability. That was true of the classical gold standard, when working people lacked the political clout to resist a monetary policy overwhelmingly geared toward stabilising the fixed-rate system. And it was true of the early postwar period, when a dominant and prosperous America found it in its interest to stand behind the Bretton Woods arrangement.

It was not true, however, of the interwar years, when national commitments to the gold standard ultimately collapsed thanks to domestic political and economic pressures. And in the 1970s, when America no longer felt the need to give thriving Europe any extra advantage, domestic considerations led to a political decision to abandon Bretton Woods.

The end of Bretton Woods led to a period of exchange-rate chaos. Many economies experimented briefly with floating only to migrate toward alternative regimes. European economies quickly moved to build a new managed-rate system, while many emerging economies used pegs to anchor domestic monetary policy. The spectacular collapse of some fixed-rate regimes in the 1990s led to a brief surge in floating, but by the early 2000s that had given way to the regime known as "Bretton Woods 2". In that system many economies, especially rapid industrialisers like China, followed a crawling peg or managed float against the dollar, maintained primarily through massive accumulation of dollar-denominated foreign-exchange reserves. The upshot of the system was a large and persistent American current-account deficit accompanied by huge foreign lending to the American economy.

Strikingly, Europe's internal monetary system developed similar imbalances, though for different reasons. Northern capital flowed south in search of higher returns, rather than as part of a drive to build a precautionary savings hoard. That difference helps explain why, though both systems experienced problems after 2008 only the European system sank into serious financial crisis: demand for safe dollar assets when trouble struck while demand for riskier peripheral bonds tumbled (until the European Central Bank intervened decisively).

Where does all this leave the world economy? Well, no one seems particularly happy with the current monetary system, but that does not necessarily imply that it must end. One can imagine a regime that is generally happier and more robust: in which many more economies float, China stops...
managing its currency and frees its capital account, and the dollar's role as reserve is increasingly shared among several currencies. But that wouldn't solve Europe's problems. Neither is it apparent that China sees such an evolution as in its interests.

The most important question may be whether rigidities in the system are constraining enough to make another big crisis likely. I worry the answer is yes. Countercyclical policy has been dampened by the zero lower bound, fiscal-policy constraints, and central bank unwillingness to break with 2% inflation targets. Normally, exchange rates might help facilitate more of an adjustment, but the stabilising function of depreciation is explicitly off the table within the euro zone and muted, in America, by exchange-rate management against the dollar. It seems difficult to believe that domestic constituencies across the rich world will continue to tolerate a "secular stagnation" environment indefinitely: with low growth, low interest rates, and low inflation.

It seems particularly easy to believe that another major shock would break some part of the system. Economies might intervene in foreign-exchange markets, to provide emergency monetary stimulus, or might shut them down altogether. There could be intense pressure to restrict trade if some economies use depreciation as a stimulus tactic while others do not. During the global financial crisis, there was an impressive global commitment to keep global goods markets open. But that commitment may not persist, and other parts of the system are less beloved.

It seems crazy to court disaster when such attractive alternatives exist. As our recent piece noted:

    Fixed rates can reduce borrowing costs, but the result is often a debt-binge and crisis. Modern technology reduces currency transaction costs. IMF research finds that flexible exchange rates reduce vulnerability to both macroeconomic and financial crises. And Joseph Gagnon of the Peterson Institute for International Economics, a think tank, finds that economies with floating currencies did better in the global financial crisis and its aftermath.

The world may yet find its way to floating rates. But it seems more likely to stumble into it via crises than to stroll there in sensible and coordinated fashion.