

Running the world's central bank

Whether he likes it or not, Ben Bernanke will be running the world's central bank, says **Edwin Truman**. If he does it well, it will be good for America too

On February 2, the Greenspan Federal Reserve will become the Bernanke Federal Reserve. It will be in good hands. The reason is not because Ben Bernanke is a worthy successor to Alan Greenspan, though he is. The reason is not because Bernanke offers continuity and the transition to his leadership has been well-managed, though that also is true. The reason is that the Federal Reserve is first about substance, second about the institution, and only third about the individuals who lead it. However, all three elements will shape the assessment of the Federal Reserve when Bernanke steps down four to 14 years from now.

The principal challenge the Fed faces over the next decade is how it performs as the central bank for the world. The Fed is uncomfortable playing this role, but it is undeniable that the American central bank is increasingly called upon to do so. It must draw upon its substance – sound analysis of the right issues, its institutional strengths at the centre of the American and global financial system, and its people, including the chairman of the Federal Reserve Board and the Federal Open Market Committee (FOMC) – to ask the right questions and promote the right answers.

Monetary policy

When most people talk about the Fed, they focus on the glamorous part – monetary policy. Here, the Bernanke Fed will be no different from the Greenspan Fed because Bernanke never really

left after being appointed chairman of the president's Council of Economic Advisers (CEA) last June. He continued as a *de facto* non-voting member of the FOMC.

As the Bernanke FOMC moves forward, it will face a relatively easy task. It must be careful to get the economics “wrong”. It would be easy to get the economics “right”, to follow the conventional wisdom of the day and call an early halt to the rise in the federal funds rate so as not to crunch the American economy. However, the FOMC might be unwise to do so because the conventional wisdom might be wrong.

Risks ahead

How well is the Greenspan-Bernanke FOMC doing? The American economy faces three major risks: asset prices, inflation and external adjustment.

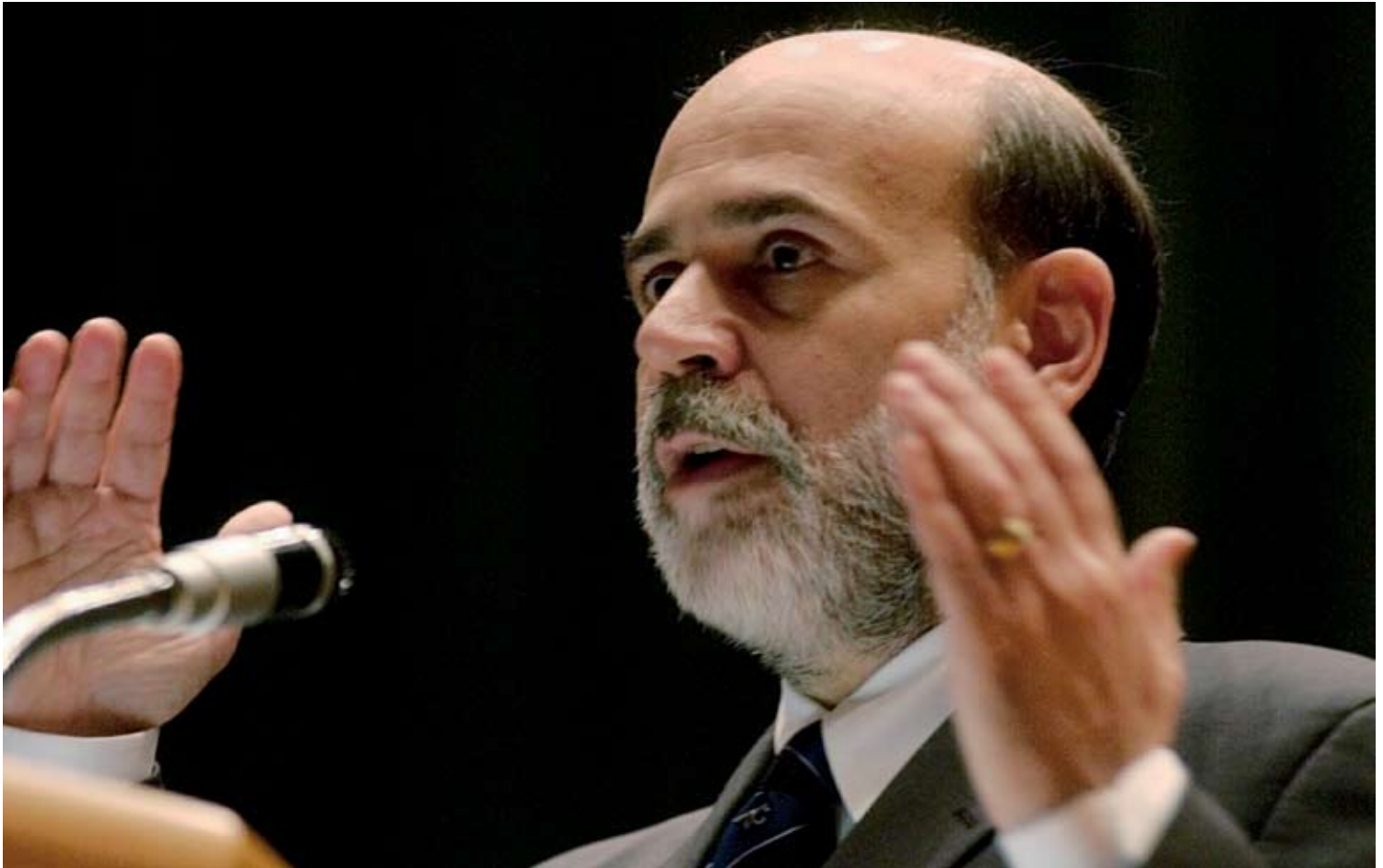
On asset prices, principally domestic house prices, the FOMC might get the answer both right and wrong because of the lack of consensus about what the right economics is. However, if it turns out that the FOMC has had the economics truly wrong and overestimated the extent of the bubble and, therefore, of the required rate rise, the consequences will not be terribly severe. The slowdown in American economic growth might be somewhat more than necessary or expected, but it is highly unlikely that the economy will experience an immediate recession.

On inflation, the FOMC has been somewhat behind the curve on its own terms. The FOMC's preferred summary measure of inflation – the deflator for core personal consumption expenditures – has been running close to or above 2%

for more than two years. The last time this happened was in 1995, when the federal funds rate was pushed up to 6%. Here, the FOMC is likely to get the economics “wrong” and disappoint the market by pushing the federal funds rate up to about 5.5%. However, the economy will not suffer severe consequences if the FOMC initially stops prematurely or tacks on an unneeded 50 basis points (hundredths of a percentage point) to interest rates.

On external adjustment, the FOMC is even further behind the curve. First, it was not appropriate for the FOMC to have pursued so accommodative (low interest) a monetary policy from 2002 to 2004 when the dollar was depreciating and the current account deficit was widening further. Second, the FOMC is wrong, on balance, to assert that monetary policy has no role in external adjustment. The principal effect of monetary policy is on demand. The widening of the American current account deficit reflects more rapid growth in American demand than in American supply. If the current account deficit is a problem, or turns out to be a problem, then the FOMC policy should bear part of the blame. Third, if the American trade balance starts to narrow significantly in real terms over the next year, as a consequence of faster growth abroad, the lagged effects of the weaker dollar or a resumption of dollar depreciation, the peak in the federal funds rate should be higher than 5.5%. I am confident that the FOMC will get this monetary policy call right.

I am equally confident that Greenspan and Bernanke have been unwise to be perceived as cheerleaders for the view that the inevitable



process of global adjustment will be smooth. The principal reason is that, despite its protestations, the Fed is the central bank for the world and, therefore, the institution that is most responsible for global monetary stability. This responsibility extends beyond monetary policy to policies affecting the global financial and payments systems. It has been a mistake to sound complacent when there are risks, even if those risks have a low probability of materializing.

The unavoidable role

The Federal Reserve is not comfortable with its role as the world's central bank. Fed officials correctly argue that its mandate is to promote full employment and price stability at home, not in the global economy. They are also correct to argue that achieving full employment and price stability in America is the principal way to contribute to global economic and financial stability. However, the acceleration of global economic and financial integration means that it is increasingly difficult for the Fed to compartmentalize its monetary and financial policies, to maintain that it only takes account of their domestic effects and implications and to ignore their external influences that, in turn, affect the domestic economy. Fed officials know this. They also know that their first priority is to do what is right for the domestic economy. They know, finally, that they ignore the international implications of their policies and developments in the rest of the world at a peril to their overall objectives.

Thus, the principal challenge facing the Bernanke Federal Reserve over the rest of the decade and beyond will be to manage this role as

Ben Bernanke becomes chairman of the Fed in February


the world's central bank. It has three tools for doing so: engagement, outreach and initiative.

On engagement, the Greenspan Federal Reserve played a significant role in transforming the Bank for International Settlements into a global institution. It has also been supportive of the nascent Group of Twenty (G-20), which brings together finance ministers and central bankers from rich countries, big oil exporters and most of the big emerging markets. This group is potentially more relevant to addressing successfully global economic and financial issues than the antiquated Group of Seven (G-7), the rich-country club. The Fed also plays a major role in the Financial Stability Forum, an international group of national authorities responsible for stability in major international financial centres. It is essential that the Bernanke Federal Reserve build on these activities.

The Greenspan Fed was active in promoting cooperative research and solutions to common global problems, ranging from the Y2K transition and the aftermath of 9/11 to Basel II. I have no doubt that the Bernanke Federal Reserve will continue this trend, in part because Bernanke promoted it while he was a member of the Fed board.

The Greenspan Fed was selective about the initiatives that it undertook. Under Greenspan, the Fed tended to engage on international economic and financial issues only when the issues became too important to ignore (the Mexican or East Asian financial crises), when invited to do so by

the administration (relations with China) or when instructed to do so by Congress (global cooperation on money-laundering).

My hope is that the Bernanke Fed will be more proactive in international financial affairs while operating within the *de jure* constraints of its mandate and the *de facto* constraints of its relations with the Congress and the administration. For example, Bernanke and his colleagues should seek the ways and means to strengthen the institutions of global cooperation, such as the International Monetary Fund, and regional institutions, such as the North American Free Trade Agreement. If the Fed successfully enhances those institutions through its own policy initiatives, some of the burden of acting as central bank for the world will be relieved. 



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