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 protesta-
tions, 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 pay-
ments 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 con-
tribute to global economic and financial stabil-
ity. However, the acceleration of global economic
and financial integration means that it is increas-
ingly 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 influ-
ences 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 domes-
tic 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 suc-
cessfully 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 interna-
tional group of national authorities responsible
for stability in major international financial cen-
tres. 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 eco-
nomic and financial issues only when the issues
became too important to ignore (the Mexican or
East Asian financial crises), when invited to so by
the administration (relations with China) or when
instructed to do so by Congress (global coopera-
tion 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 rela-
tions with the Congress and the administration.
For example, Bernanke and his colleagues should
seek the ways and means to strengthen the insti-
tutions of global cooperation, such as the Inter-
national Monetary Fund, and regional
institutions, such as the North American Free
Trade Agreement. If the Fed successfully
enhances those institutions through its own pol-
icy initiatives, some of the burden of acting as
central bank for the world will be relieved.

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