The Next Fed Chairman’s Global Clout

By ESWAR S. PRASAD

The U.S. Federal Reserve remains the most powerful central bank in the world. Its policy actions reverberate in every corner of the globe, something no other central bank can claim. Even the hint of a “taper” — the withdrawal of easy money policies — has roiled emerging markets. The prospect of rising interest rates in the United States has led investors to pull back from riskier investments in those countries. Emerging markets like Brazil, India and Indonesia are facing plunging currencies and declining stock markets.

Low interest rates in the United States had led investors to look to emerging markets for better returns on their money, fueling booms in equity and real estate markets as well as higher inflation in some countries. For the previous two years, emerging markets had been complaining about how these inflows fueled by cheap money in the United States caused their currencies to appreciate too rapidly, hurting their export competitiveness. The fact that those same currencies are now tumbling has led to the opposite complaint — that the Fed should back off more slowly from its earlier policies and better communicate its intentions to financial markets.

Given the global impact of the Fed’s actions, the choice of a replacement for Ben Bernanke as chairman of the Federal Reserve is being watched with keen interest. No matter who is chosen, there are important changes in store for central banks and financial markets the world over.

Despite the global economic crisis, financial markets are now more closely connected then ever before. China, India and other major economies have continued removing restrictions to capital flows, opening up their markets to cross-border investment. Given this increased mobility, actions by any of the major central banks have effects well beyond their own national borders.

Moreover, in the aftermath of the crisis, central banks have become even more important to economic management, taking on much of the burden of controlling inflation, improving financial stability and promoting growth. This is a difficult balancing act in the best of times. It becomes virtually impossible when fiscal and other policies are working at cross-purposes.

In the United States, for instance, short-term fiscal tightening (along with the uncertainty associated with deficit and debt-ceiling negotiations that repeatedly go down to the wire) has hobbled the recovery. Meanwhile, little has been done to tackle the longer-term fiscal problems,
especially entitlement spending. The focus on short-term austerity has limited productivity-enhancing expenditures in such areas as infrastructure and education.

In India, the government has been unwilling to undertake politically unpopular reforms to tackle large budget deficits and structural problems such as stifling labor-market regulations. This has left it to the makers of monetary policy to do all the heavy lifting. Other emerging markets face similar issues.

The reliance on central banks to make up for the failings of other policies has created inevitable international tensions. The right monetary policy for one country might not necessarily be what is good for another. Unlike fiscal policies, whose effects tend to stay mostly domestic, monetary policies do affect currency values and financial markets in other countries through cross-border financial flows.

Whoever takes over from Bernanke, the reality is that the Fed chairman has a mandate to focus only on domestic objectives. Fair enough: No central bank in the world has anything but domestic objectives in its mandate. But when the Fed acts, it matters to the world in a way that no other central bank’s actions do.

In a report by a committee of academics and former central bankers in which I participated, we argued that the Fed and a small group of central banks from both advanced and emerging market economies should hold regular meetings and issue a report on their monetary policy intentions. Even if this procedure only exposed mutual inconsistencies in policy, it would be a way to bring broader pressure on politicians to stop relying on the crutch of monetary policy and prod them to take politically unpopular measures to improve productivity and the prospects of long-term growth while making global capital flows more stable.

So who would the rest of the world vote for to head the most important central bank? Now that Lawrence Summers has withdrawn from the race, the presumptive front-runner is Janet Yellen. Many central bankers view her as someone who is empathetic to the spillover effects of U.S. policies, someone who has enough credibility to soothe financial markets and ably steer the Fed.

In any event, no matter who gets the job, what many of the world’s central bankers are hoping for is a Fed that can go back to the more modest objectives of maintaining low inflation and financial stability. On that, at least, there is certainly international agreement.

**Eswar Prasad** is a professor of economics at Cornell University and a senior fellow at the Brookings Institution. He is the co-author with M. Ayhan Kose of “Emerging Markets: Resilience and Growth Amid Global Turmoil.”