Does the Fed Need a Foreign Policy?

Few U.S. institutions have more influence on other countries, and as we are about to see a hike in interest rates, it just might be time to make the Fed even more global.

BY JEFFREY E. GARTEN | AUGUST 10, 2015

In a summer of foreign-policy breakthroughs — which include the nuclear treaty with Iran, the normalization of ties with Cuba, and the congressional granting of fast-track trade negotiating authority to the White House — U.S. President Barack Obama, Secretary of State John Kerry, Secretary of Defense Ash Carter, and U.S. Trade Representative Michael Froman stand out as the important shapers of America's changing foreign relations. But this fall someone else will have an outsized impact on how the United States relates to the rest of the world. That person doesn't have a seat on the National Security Council, doesn't negotiate treaties, and almost never confers with the president on policy matters. That person would be Federal Reserve Chair Janet Yellen.

As Yellen has been saying for months now, the U.S. Federal Reserve is preparing to raise interest rates as early as next month but no later than December. She delivered a typical Fed-speak alert at the City Club of Cleveland in July. "Based on my outlook, I expect that it will be appropriate at some point later this year to take the first step to raise the federal funds rate," she said, referring to the key benchmark interest rate that the Fed controls, the rate at which banks lend short-term funds to one another. Figures released by the Labor Department on Aug. 7 showing relatively positive job creation now adds momentum to rates being hiked sooner rather than later. Coming after seven years of near zero interest rates, the decision signifies an upcoming era of more normal monetary policy. It is fraught with implications for U.S. investors, savers, traders, and bankers. Everything from pensions to mortgage loans will be affected, not to mention the pace of GDP growth.

The impact will not be felt just in the United States, however, for increased rates will have huge ramifications abroad. It will drive the GDP of many countries, affect the cost of their debt service, the behavior of their banks, and the activities of their investors. It could also lead to serious local and geopolitical consequences that come with new economic and financial strains. For example, new economic pressures on Turkey could undercut its willingness to take in Syrian refugees, or it could affect the resources it will devote to fighting the Islamic State. Tightening economic conditions on Indonesia could make the country turn increasingly inward, with negative implications for the integration of the Association of Southeast Asian Nations, or ASEAN. Such international implications raise a number of questions. What obligations does the Fed have to take into account global financial conditions when it makes its decisions? What obligations does it have to consider the impact of its decisions on other countries? And is there anything that can be done to strengthen the Fed's de facto foreign policy?

The Fed's global impact

Through its monetary policy, the Fed influences the pace of America's economy. Since the United States constitutes more than 20 percent of the global GDP and has an open economy, the country's growth rate has a substantial impact on the buoyancy of global trade and investment around the world.

America has the world's largest, deepest, and most liquid capital markets with linkages to foreign ones. Thus, U.S. interest rates influence virtually all securities trading around the world.

The dollar is the world's most important currency, used everywhere for trade, investment, and reserves. Interest rates affect the relative value of the greenback.

If interest rates rise, emerging-market nations — where the economies, banks, and companies are more fragile than, say, those of Germany or Australia — could be hit especially hard. Because investors abroad would be chasing higher returns in the United States, huge amounts of foreign money could surge into the country from other nations, sucking out capital from states such as Indonesia, Brazil, Turkey, and South Africa. That's exactly what happened in 2013 when then-Fed Chair Ben Bernanke hinted that the Fed was about to "taper" its purchases of U.S. securities, which would have had the effect of raising interest rates. Following his announcement, in a number of emerging-market economies bond prices plunged, stock markets sunk, and currencies fell. This set of events has been labeled by the media and the market as the "taper tantrum."

Another possible impact is that the money coming into the United States would cause the dollar to strengthen. Since it would take more local currency to purchase dollar-indexed commodities, the demand for commodities would fall, causing their prices to decline and putting pressure on emerging-market commodity exporters such as India or Chile. That could be especially destabilizing right now, as commodity prices are at a six-year low. Of course, oil is the world's most important raw material, and oil exporters — Saudi Arabia, Iraq, and Nigeria — could also take an even bigger hit than already low petroleum prices are delivering.

Private companies in emerging-market economies are also at risk. In 2012, 2013, and 2014, firms such as Brazilian sugar producer Grupo Virgolino de Oliveira or Malaysian oil and gas behemoth Petronas borrowed extensively in dollars. As the dollar increases in value against their local currencies, their dollar-denominated debts could be much more expensive to service, causing strains for some and bankruptcy for others.

(There is one mitigating factor, however. A strong dollar could give a boost to U.S. imports, such as furniture and clothing, because they would be relatively cheaper for Americans. That, of course, would be the same as giving a boost to other nations' exports. A more powerful greenback could also make U.S. exports of products, such as autos and medical equipment, more expensive, giving yet an additional advantage to other countries selling on the world market.)

The biggest concerns surrounding a rise in interest rates is the unknown impact on global buying and trading of a variety of risky, speculative assets. Because interest rates have been so low for so long — since 2008, in fact — investors searching for higher returns have gravitated to ever riskier assets, such as corporate junk bonds, which give them higher yields. Once interest rates go up, investors could rush to unload these risky securities and move on to safer assets with a more decent yield that results from the Fed's interest rate increase. The question is whether there will be enough buyers to match the volume of securities being unloaded. The reason for concern is that new banking regulations stemming from the 2008-2009 financial crash have put strict limits on banks' riskier activities. If banks that once would have bought risky assets are now unable to do so — in other words, if there was not enough liquidity in the system — a full-blown global crisis could ensue.

In the context of Yellen's upcoming decision to raise interest rates, the interaction of the United States and the rest of the global economy is particularly significant right now. The reason: There is a growing divergence between the growth of the U.S. economy, unimpressive as it might be, and the much worse performance of other countries. This situation creates serious uncertainties for continued expansion in America and even for financial stability in global markets. All this is compounded by the unknown implications of the Greek crisis, which is far from being resolved, and weaknesses appearing in the Chinese stock markets.

Bottom line: No one can predict precisely what will happen when Yellen pulls the trigger, either at home or abroad, but especially overseas. Nevertheless, concerns abound. On March 17, IMF head Christine Lagarde cautioned that the taper tantrum of 2013 could be repeated. "I am afraid [the last taper tantrum] may not be a one-off episode," she said. On April 17, José Viñals, director of the IMF's Monetary and Capital Markets Department, warned of a "super taper tantrum" to come. On June 4, Lagarde publicly expressed a view that a U.S. rate hike this year was ill-advised and should be postponed until 2016, fearing that it would cause U.S. growth to slow, with negative consequences not just for America but also for the world economy. Major financial institutions, such as BlackRock Inc., which manages nearly $5 trillion, have raised alarms that major market disturbances are in store when U.S. interest rates go up, a prediction economists at Morgan Stanley have echoed.

A view from the Fed

One of the best descriptions of how the Fed thinks about its global responsibilities came from Stanley Fischer, the central bank's highly experienced and deeply respected vice chairman, in a speech at Tel Aviv University this past May. Of all the Fed's governors, Fischer has been the most vocal and articulate on the subject of the international role of the Fed, espousing a philosophy that the bank has a very clear and highly constrained mandate to take care of the United States — but tries to do that with an awareness that America is part of an interdependent world economy.

To fully grasp what Fischer is saying, it's important to keep in mind one major background point: The Federal Reserve System is not part of the administration. It has at its core the status of being independent. It reports and is ultimately beholden to Congress, but it doesn't rely on appropriations for its budget, earning money through its financial transactions (and actually returning large sums to the Treasury, too). Even more so than other "independent" regulatory agencies, it therefore acts independently of the Executive Branch and, from an operational standpoint, of Congress, too. Fischer then makes a number of key points that I have summarized here:

First, as he explains, the legislative basis for the Fed's activities makes it indisputable that the bank's role and responsibilities are confined to the United States only. Its policies must be geared toward two objectives — and only these two: full employment and price stability in the United States. There is nothing in its formal mandate that demands considering the impact of its actions on other countries.

But second, he says that in an interdependent world, the Fed is keenly aware that conditions abroad — growth rates, central banks' monetary policy, currency movements, and financial crises, for example — affect what happens within America's borders, and thus such developments must be factored into the bank's calculations. Minutes of the last session of the Fed's internal deliberations in mid-June make this clear with references to discussions that encompassed the status of U.S. exports, the relative value of the dollar, foreign country growth rates, international bond prices, and problems in Greece and in the Chinese stock market.

Third, Fisher also says the Fed takes into account any damage that its actions could do to hurt foreign economies. That's because if the Fed's actions weaken foreign markets, it could boomerang against the United States. Markets abroad could be deflated, damaging U.S. exports and U.S. foreign investors. Also, a financial crisis could be ignited abroad, with possible contagion effects on the United States. These potential problems, Fischer says, puts a very high premium on clear communications about U.S. intentions — including the rationale and even the criteria for when a decision will be made — so that other nations can prepare themselves to take policy measures that will shield them from negative impact. Thus, Yellen has gone to great lengths to spell out why and when an increase in interest rates will be necessary, and has even explained from what basis the decision to do so will be taken. If a country such as Brazil or Malaysia gets adequate warning from the Fed that the bank intends to raise rates and attract foreign capital to the United States, it thus has time to take whatever policy measures it needs to cushion the impact. For example, the country could raise domestic interest rates to keep capital from flowing out.

Fischer's fourth point is that the Fed has extended help to other countries to maintain financial stability. In the crisis of 2009, for example, the Fed lent dollars to several other central banks, such as the Bank of Mexico, the Bank of Brazil, and the Bank of Korea, in order for them to have enough greenbacks to stand behind their banks that were using the dollar for critical trade and investment transactions. It's not easy to disentangle motives here. Does the United States do this out of some kind of loyalty to friends and allies, or does it do this because it wants to prevent a global crisis from getting worse, with negative reverberations for itself? Or both?

The vice chairman makes a fifth and central point. The ultimate responsibility of the Fed, he says, is to help keep the American economic and financial house in order. It alone cannot do this — the fiscal authorities must help — but if the United States is growing, if its debt is being well-managed, and if it stays open for commerce and immigration — then it will have provided a very substantial benefit to the rest of the world.

In the end, however, Fischer is keen to underline the limits of the Fed's role: "But I should caution that the responsibility of the Fed is not unbounded," he said. "My teacher Charles Kindleberger argued that stability of the international financial system could best be supported by the leadership of a financial hegemon or a global central bank. But I should be clear that the U.S. Federal Reserve System is not that bank."

What to take from all this? Fischer is walking a very fine line. He wants us to know that the Fed is doing what it can within its legislative mandate. He doesn't want to stretch the mandate, let alone challenge it. He wants the world to know that the Fed is well aware of its global impact and that it is not without its concerns about how other countries are affected. But he's also saying, "We are not a global central bank. We do not have responsibility for your welfare, just for ours."

The view from abroad

I doubt that foreign governments, especially those of emerging-market nations, are too comforted by what Fischer says. They no doubt understand it. They harbor no expectations that the situation will change. But they still have problems with the role of the Fed as it affects them.

For starters, neither they nor anyone else watching how the federal budget is being handled — or how the country's infrastructure is being neglected, or how paralyzed we are over immigration policy — is likely to believe that the American economy is all that well-managed. That may not be the Fed's fault, but it's the totality of the picture of U.S. policy that is being flashed abroad. Besides, Fischer's explanation didn't stop other countries from expressing their serious annoyance when, in 2008, rates were loosened, the dollar depreciated, and it appeared that the United States was manipulating its exchange rate to gain competitive advantage. (American officials, such as then-Chairman Ben Bernanke, vigorously asserted that this wasn't the case and that they were boosting the U.S. economy, which should benefit other countries.)

Furthermore, my guess is that many foreign governments feel they are on the end of a leash that gets yanked because of what matters to Washington and Wall Street — and not to them. What must irk many overseas is that the dollar, for which the Fed shares responsibility with the Treasury, can gyrate depending on short-term partisan American politics. Case in point: When Congress threatened to default on the debt in order to get leverage on budgetary issues, as it did in 2011 and 2013, markets abroad justifiably became apprehensive that the world's sole superpower would act irresponsibility with no concern whatsoever for the international implications.

Could the Fed do better?

Let's stipulate that the legal constraints on the Fed are very real. Let's also remember that the independence of the Fed imposes a major constraint insofar as being able to coordinate with other government agencies and that an independent Fed has critical merits insofar as it can make monetary policy without political interference. And let's agree that the Fed is but one actor in the conduct of U.S. global financial and economic policy. Can the Fed still have a more effective foreign policy? I believe a few things can be done, but even more important, a framework for thinking about the Fed in the global economy is worth keeping in mind. That includes certain actions the administration and Congress should take to reduce pressure on the Fed to be so influential abroad.

Here then is a future agenda to help insure that the policies emanating from the Fed to the world beyond our own borders better serve the country's intertwined domestic and international interests.

Keep up the great record on communications. It's hard to see how the Fed can improve on Yellen's constant messaging about U.S. intentions, including her stated plan to raise interest rates in small increments over a longer period of time. All countries outside the United States have been put on notice for many months and have had time to prepare. That said, the global financial system has many vulnerabilities and many unknown interconnections, particularly in the unregulated banking sector — the so-called "shadow banking system" — and crisis managers must be extremely alert to any problem that could metastasize into something bigger. I hope the Fed has contingency plans for the United States and also for helping other governments, if an increase in rates creates a crisis.

Continue with the sterling appointments to the Fed Board. It really does matter who runs the Fed, and the global experience and sensitivities they bring to their position. I feel that the United States — and the world — has been extraordinarily fortunate to have had such leaders as Bernanke, Yellen, and Fischer at the helm of our most important financial institution, an institution that has so great an impact on global affairs. I also applaud the appointments to the board of governors of such people as Daniel K. Tarullo, who is steeped in the arena of law and regulation in the United States and abroad; Lael Brainard, a former undersecretary of the treasury for international affairs with extensive experience in dealing with international financial institutions and in economic development in emerging-market countries; and the nomination last month of Kathryn Dominguez, a professor at the University of Michigan, who is an expert in foreign exchange, emerging markets, and international borrowing. Keeping up such quality is not easy but imperative.

Consider expanding the Fed's physical global presence. In a world in which markets are increasingly interconnected, and in which shocks can be transmitted across borders in nanoseconds, is there a case for expanding the ability of the Fed to think and act more globally? I could argue that there is. Since its establishment in 1913, the Fed has been structured to look inward, comprised as it is by 12 regional Federal Reserve Banks. Anyone who has done serious business outside the United States knows that having a presence on the ground is essential to fully understanding what is going on in any given country. Even the Internet and all it allows by way of real-time communication isn't enough to get as granular a feel for what's going on in foreign jurisdictions as being there, talking and interacting with the men and women on the ground. What about the Fed setting up offices in London, Geneva, and Tokyo to bring it closer to the underlying financial rhythms around the world and the people who are responsible for them?

Consider allowing foreign central bankers to participate in Fed deliberations. An equally radical idea: What about allowing carefully selected official observers from other key central banks — someone such as Mario Draghi, president of the European Central Bank — to sit in on key Fed meetings in order to share their perspectives about the impact of what the Fed is debating? Presumably, there would be reciprocity, thereby bringing the most important central banks closer together in their understanding of one another's mindset and constraints.

Appoint a roving ambassador. On any given month it seems that one of the Fed governors or one of the presidents of a regional federal reserve bank is giving a speech abroad or participating in an international conference. In addition some governors are regularly meeting with counterparts at regular gatherings of the Bank for International Settlements in Basel, Switzerland, the club for central bankers. While these activities bring U.S. officials in touch with what's going on overseas, such engagement can be stepped up and made more strategic. Also, it would be good to get outside the relatively narrow range of men and women who work in central banks and other regulatory agencies, given that the impact of the Fed's decisions can be so broad on foreign societies. Why not create a position of ambassador-at-large for one governor? He or she would have as a mission interacting with a broad variety of people outside the United States, including a wide swath of government officials, private sector leaders, civic groups. That person would be responsible for in-depth briefings before the Fed board and in advance of key monetary or regulatory decisions. The "ambassador" would not substitute for the international contacts of other governors but add to them. The establishment of this position would be evidence that the Fed has gone the extra mile to take into account the global impact of its actions. Even if its policies remain the same, other nations would at least know that outcome wasn't out of arrogance, or disinterest, or a mindset reflecting the narrowest interpretation of its domestic mandate.

With regard to the three suggestions just mentioned, no new legislation should be required. After all, who can object to the Fed doing its domestic job better, by getting deeper insights into the world economy that affects the United States in very important ways?

Relieve pressure on the Fed by getting a grip on fiscal policy. In the medium term, Washington must relieve the Fed of the pressure to shoulder so much responsibility for U.S. growth and stability. Since 2010, for example, fiscal policy has been immobilized because of congressional infighting. The stimulus we have needed to mount a recovery has fallen disproportionately to the Fed. The Fed was never created to be the sole actor in this manner. Far more of the burden should be borne by fiscal policy — by tax and spending programs that create long-term investments in infrastructure, technology, education, and job and skills training. Of course, today it seems far-fetched to envision a responsible, bipartisan approach to the federal budget, but had there been one in place, the Fed would never have been in a position to keep rates so low for so long and to now be forced to raise rates for a long time to get back to normal.

Redouble support for the IMF. The Obama administration needs to find a way to support the IMF to a much greater extent than it has to date by mobilizing Congress. The IMF is, after all, the one and only truly public international financial institution, and it does have a mandate to consider the global implications of all financial policies. The Fund needs financial resources, for sure. But it also needs political reform, so that China and other big emerging-market nations have a vote that is commensurate with their rising significance in the global economy. Congress has been holding up legislation that would allow the IMF to do just that. The danger is not just that Capitol Hill is eroding other nations' confidence in U.S. leadership, but that China may well move to create a rival institution in which it does have an appropriate voice.

Plan seriously for the establishment of a multipolar currency system. The United States should figure out how to lead in the establishment of a multipolar global economy with multiple reserve currencies. This is not just an imperative to reflect changing power structures, but it could take pressure off the Fed to be the world's central bank, because that is never going to happen. As I wrote in Foreign Policy last month relating to China's role in global finance, the time to envision this architecture and how we get to a new system is now, while U.S. leadership is clear.

Foreign policy and the Fed

We often think of foreign policy as falling into categories, such as hard power and soft power. Much of the discussion often takes place about the need to better integrate different strands of foreign policy in the interest of gaining more coherence and leverage. But thinking about the Fed and foreign policy adds a new and more difficult dimension to such concepts. The Fed may not exercise hard power in the way the military does, but there is nothing soft about having a critical influence on the economies of other countries. And when it comes to integration with, say, the policies of the State or Defense departments, the Fed is not legally able to do anything like that. The impact of the Fed's policies on other countries, in particular, and on the world economy in general is massive, however. It is also a face of America, no matter how independent of the administration its statutory status makes it.

Moreover, this challenge to the Fed and to America's relationships around the world is not going away. The upcoming rise in U.S. interest rates is just step one in a long road to higher rates. And it is just a curtain raiser for a much bigger drama; for down the road, the Fed will begin to unwind its $4 trillion balance sheet that it has built up since the financial crisis, very likely creating even more significant waves in global financial markets.

Meanwhile, we should root for a Federal Reserve that stretches its strict mandate to focus on the U.S. economy as far as it reasonably can within its legal mandate, recognizing that the line between what is domestic and international is fuzzier than ever. And the administration and Congress should wake up to their responsibilities to follow policies that take the burden off the Fed to be so prominent globally. That's not a very satisfying conclusion, but for now, it's the best that the Fed and Washington can do.

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