# The world's reluctant central banker

By Andrés Velasco
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This is supposed to be the era of powerful central banks, ready to wield their firepower worldwide. Yet the most powerful of all central banks – the United States Federal Reserve – is also the most reluctant to acknowledge its global reach.

Like all central banks, the Fed has a local mandate, focused on domestic price stability and employment. But, unlike most central banks, the Fed has global responsibilities. This tension is at the root of some of the most threatening problems facing the world economy today.

The Fed has global responsibilities for two closely related reasons, neither of which has much to do with the need to avoid the "currency wars" that so concerned former Brazilian Finance Minister Guido Mantega.

First, despite the birth of the euro and talk of the Chinese renminbi's ascendancy, the dollar remains the currency of choice for borrowing and lending around the world. When a bank or corporation in Kuala Lumpur, São Paulo, or Johannesburg borrows abroad, the loan is more likely to be denominated in dollars than in any other currency.

If local banks suffer a run, or if corporations have trouble rolling over their debt, they need to be able to borrow dollars from the local central bank, which in turn may have no choice but to get those dollars from the Fed. When the Fed in 2007-2008 entered into swap agreements with 14 central banks, including those of four emerging economies (Brazil, Mexico, Singapore, and South Korea), it *de facto* acknowledged that it is the world's lender of last resort in dollars.

Yet the Fed, its governors argue, cannot be expected to do that on a regular basis. In a 2015 speech, Stanley Fischer, one of the most internationally-minded of the Fed's governors, acknowledged that world financial stability could be supported by a global central bank, yet concluded: "I should be clear that the US Federal Reserve is not that bank."

The second reason why the Fed has global responsibilities is that its policies affect monetary conditions worldwide. There is mounting evidence that monetary-policy shocks affect risk premia, and that this channel operates internationally as well as domestically, with sizeable effects. In the 2013 episode known as the "taper tantrum," the mere hint that the Fed might slow the pace of its bond-buying program triggered large capital outflows and asset-price drops in most emerging economies.

The traditional Fed response, expressed eloquently by former Fed Chairman Ben Bernanke at the 2015 IMF Research Conference, is simple: Float your currency. The standard trilemma of international monetary policy holds that countries cannot have fixed exchange rates, monetary independence, and free capital movement simultaneously, but they can have two of the three. Countries that float their currencies can be free to set interest rates and determine financial conditions at home, even with substantial international capital mobility. If they don't float – because they have targets for exports or the real exchange rate – that is their problem. The Fed, Bernanke argued, cannot be expected to help them.

But Bernanke's argument is not entirely convincing. As London Business School's Hélène Rey has argued, the "risk-taking" channel of monetary policy is so powerful internationally that Fed policy helps determine credit conditions in many countries quite independently of their exchange-rate regimes. When the Fed loosens policy, credit grows all

over the world, and vice versa. So it is not a policy trilemma but a dilemma: capital-account restrictions –not just flexible exchange rates – may be necessary for central banks to exercise effective control over domestic credit conditions.

The Fed's reluctance to serve as the world's lender of last resort, or to acknowledge that exchange-rate movements cannot undo its actions abroad, would seem to condemn it to being a parochial and inward-looking institution. But Donald Trump should not start applauding yet.

The Fed's domestic mandate requires it to recognize, in Fischer's words, that "the US economy and the economies of the rest of the world have important feedback effects on each other." And those effects are getting larger.

When justifying its interest-rate decisions, the Fed has historically paid little attention to the effect of international conditions on the US economy. But it broke with tradition in September 2015. Both the official minutes of the rate-setting meeting and Chairman Janet Yellen in her press conference mentioned heightened uncertainties abroad, including weakness in the Chinese economy, as key reasons to delay the Fed's increase in interest rates.

Other international linkages are also receiving greater attention. As the US economy becomes more open to international trade and capital movements, the dollar's value matters more because of its effect on inflation and on domestic financial conditions. In the current debate about what the Fed should do next, Governor Lael Brainard has been arguing that real dollar appreciation of 20% in 2014 and 2015 reduces the need for further monetary-policy tightening.

Of course, caring about how the world affects the US is not the same as concern about the economic health of the rest of the world. And yet these small steps are significant. Berkeley's Barry Eichengreen has shown that international considerations have long played a key role in the conduct of Fed policy, and that the last three decades, in which the Fed turned mostly inward, were something of an aberration.

So perhaps the 102-year-old Fed is returning to its original tradition. Or perhaps its outlook already is quite internationalist – as its actions during the financial crisis suggest – and it is only domestic political constraints that prevent this from being acknowledged openly.

Either way, even incremental movement in this direction is welcome, for the last thing the world needs is a parochial Fed. Recent financial history suggests that the next liquidity crisis is just around the corner, and that such crises can impose enormous economic and social costs. And in a largely dollarized world economy, the only certain tool for avoiding such crises is a lender of last resort in dollars.

The IMF could have been that lender, but it is not. The Fed is. The sooner the US and the rest of the world fully recognize this, the safer the world economy will be.

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