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The Fed’s bad manners risk offending foreigners

By Willem Buiter

Central bank should take account of the external impact of its actions, writes Willem Buiter

People are responsible for the foreseeable consequences of their actions, whether or not they intend to cause them. The Federal Open Market Committee, which sets monetary policy in the US, is no exception.

Many have expressed surprise at the Fed’s silence on the financial turmoil in emerging markets. Its statements since June 19 2013 have made no reference to economic conditions outside the US. They could have been written by the central bank of a closed economy.

Following the Fed’s premature announcement on May 22 that it would begin to scale back its $85bn-a-month bond-buying programme, many emerging markets experienced a sudden reversal of capital inflows followed by sharp exchange rate depreciations, large increases in longer-duration domestic currency bond yields and significant stock market declines. These effects were especially pronounced in India, Indonesia, Brazil, South Africa and Turkey.

On September 18 the Fed changed its mind, and announced that it would not yet taper its asset purchases after all. This led to a partial reversal of the exodus of capital from emerging markets and a partial recovery in asset prices. In the past month, however, there has been a second bout of unrest. In part this was the result of political instability and economic mismanagement in countries such as Turkey and Argentina. But it was exacerbated by renewed worries about tapering and fears that the Fed might raise interest rates sooner than previously expected.

Some argue that the Fed should not worry about the effects its actions have on emerging economies. Its mandate is to promote maximum employment, stable prices and moderate long-term interest rates. The Federal Reserve Act does not specifically add: “ . . . in the USA”. But this is clearly what is meant. If the Fed were to attach any intrinsic weight to the effect of its actions on the rest of the world, it might be in violation of its legal mandate.

Even if one accepts this, however, it should not prevent the Fed from taking account of the external impact of its actions to the extent that these feed back into the US economy. Through trade and financial linkages, financial and economic distress in foreign markets can come home to roost. This should be reason enough to worry about the foreign repercussions of US monetary policy. The Fed’s silence on the external impact of its policies may indicate that it believes there are no external effects. This view is untenable.

To argue that the Fed has contributed to economic and financial turmoil in emerging markets since the middle of 2013 is not to deny that many of the afflicted countries bear much of the responsibility for their predicament. Their recent structural reform efforts have been nugatory. In many places, economic policy has proved startlingly inept since the beginning of the era of low interest rates and extraordinary liquidity measures.

Nor is this to say that the Fed’s actions have been misguided. It is not even to say that an alternative Fed policy would have been better from the point of view of emerging markets themselves. It is merely to acknowledge the interconnectedness of the global financial system, and the vulnerability of most emerging markets to the monetary policy actions of the central banks of large western economies.

Raghuram Rajan, governor of the Reserve Bank of India, is right to call for more international co-operation between central banks. US policy makers should display wisdom and good manners. If the Fed creates the impression that it does not care about the consequences of its actions, it will sow anger in the emerging world. If it appears not even to understand the consequences, it will also sow fear. Neither is in America’s interest.

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