Chairman Bernanke's First Concern

What if the world economy slows?

BY DAVID M. SMICK

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W. • Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com

Reading the news commentary the morning after President Bush nominated Ben S. Bernanke for Chairman of the Federal Reserve, there was a sense the United States is about to enter a period of danger. This is because the entire discussion was solely domestic, including subjects such as inflation targeting, the stock market bubble, tax cuts, the deficit, and every other domestic concern. Missing was any mention of the brutal *global* challenges ahead for the next Fed chief.

After all, the Federal Reserve Chairman has become essentially central banker to the world. Bernanke will be working within a largely dollarized foreign exchange system in which most economies a) are seeking as strong a tie to the dollar as possible; and b) are heavily dependent on exports, in many cases to the United States, as their main engine for growth. For better or worse, America has become the global consumer of last resort in an increasingly mercantilistic world.

Many of these economies therefore have become dependent on American growth both as a market for exports but also as an attractive repository for investment (because of safety and higher U.S. rates of return), including investment of recycled dollar holdings. The downside is if the American economy stumbles. Specifically, the danger is if the Federal Reserve, in its current tightening cycle in response to rising energy prices, "overshoots," raising short-term interest rates until signs of weakness appear but by then it's too late. (Rate hikes take effect after a six to nine month lag. Once the weakness appears, a lot more tightening is still in the pipeline.) None of this may be a huge problem for the United States, but if the U.S. growth rate next year slips, say, from the current 3.8 percent to 2 percent, the international consequences, particularly for China and Europe, could be financially destabilizing. The United States develops a chest cold while large parts of the world face pneumonia.

Consider the weakening nature of the international landscape. China faces an enormous challenge—integrating a population nearly the size of Canada's into its workforce each year for the next twenty-five years. Such a goal requires virtually the impossible: 9.5 percent growth rates and 40 percent investment rates again each year, every year, for as far as the eye can see.

Recently though, Chinese inventories have started to accumulate. In response, authorities wisely are working to try to ignite consumer demand. But the over-supply of capacity, which will expand exponentially if the U.S. economy slows even modestly, has already begun to feed into

---

David M. Smick is founder, editor, and publisher of The International Economy *magazine.*

Ben Bernanke: *He is assuming the Chairmanship at a time when the global policy coordination apparatus is at its weakest.*

an explosion of production. The fear is the Chinese will, over the next year or two, try to ratchet up exports through heavy discounting. This may thrill executives at Wal-Mart but will invite the wrath of the U.S. Congress.

A lot of Chinese firms these days seem to be losing money, causing many experts to question when the banks will slow lending—a scenario in which imports would certainly plummet. Indeed, even China's current import slowdown is producing a negative spillover effect on the other Asian economies, most of which have become heavily dependent in recent years on exports to China. Note that these non-Chinese Asian markets have become important markets for European exports as well.

With China having its hands full, don't count on the European or Japanese economies to pick up the slack. Europe seems poised to join the One Percent Growth Club. One hope was that because Germany now has essentially no opposition outside of the new grand coalition government, some sort of reform growth agenda was possible. It doesn't seem likely as reform of entitlements and the labor markets, the centerpiece of any credible German plan, were quickly deemed off-the-table for discussion.

After many false starts, at least Japan appears finally to be escaping two decades bogged down in a deflationary quagmire. Sounds encouraging, yet if you remove the effects of the current oil price increase, Japan's non-energy sectors still appear to be almost as mired in the deflationary mess as before. Indeed, if the Japanese economy has truly been unchained as a result of Prime Minister Koizumi's reform efforts, why are foreigners today the only buyers of Japanese equities, with the Japanese still heavy sellers?

The new Chairman's first act should be to develop with the Administration a seasoned crisis management team.

The Fed historically almost always overshoots, knowing the long-term consequences of allowing inflationary expectations to reappear trump the short-term macroeconomic consequences of any overshooting.

Clearly, the global system faces significant risks. For a decade, the assumption in U.S. policy circles was that expansion of derivatives products would make the entire system more resilient. Yet, in this one-dimensional system, based on a model where large segments of a dollarized world have become increasingly mercantilist, depending on the United States as the consumer of last resort, no one really knows how global markets will adjust if a crisis develops.

Ben Bernanke is assuming the Chairmanship at a time when the global policy coordination apparatus is at its weakest. International economic relationships in many cases lack any real depth of understanding. Indeed, the new Chairman's first act should be to develop with the Administration a seasoned crisis management team, able to move quickly to communicate with global markets in the event of some adverse international development. Bernanke might also consider developing an international economics version of the U.S. Defense Policy Board—a selection of private experts and specialists from Wall Street and academia who meet regularly to discuss long-term problems over the horizon.

But then again, maybe the United States avoids an overshooting scenario, and 2006 becomes a banner year. That would be unusual because the Fed historically almost always overshoots, knowing the long-term consequences of allowing inflationary expectations to reappear trump the short-term macroeconomic consequences of any overshooting. Today, some policymakers are even hinting that to squash energy-related inflationary expectations, the Fed may have to drop its "baby step" tightenings and start raising rates by 50 basis point increments. If so, the global system will likely have entered unchartered waters. ◆