In a rapidly globalizing marketplace, you might think that the interests of the U.S. and the rest of the world would generally be the same. But when it comes to Washington's most critical financial decisions, the setting of interest rates by the Federal Reserve, America's actions may harm other nations--eventually to its own detriment. How can this be?

While the Federal Reserve has evolved into the role of the world's central banker, its legal mandate and its mind-set remain sharply focused on price stability and full employment in the U.S. This makes taking a truly global view extremely difficult. Fed Chairman Alan Greenspan said as much in late July, when he told Congress that despite the Fed's potential for clobbering foreign markets, "our objectives relate to domestic economic performance." The minutes of the May meeting of the Federal Open Market Committee (FOMC), the Fed's rate-setting group, also reveal strong convictions among members that the Fed should not take into account the foreign impact of U.S. actions.

Established in 1913, the Fed is a classic example of an institution created for a world that no longer exists. Back then, Washington was preoccupied with controlling a chaotic banking system, and global prosperity rested on England and the gold standard.

LONE RANGER. Today, Fed decisions have far more influence on foreign countries' interest rates, currencies, stock markets, commodity prices, real estate values, and gross domestic product. Because economics are driving politics in emerging markets, the Fed can create either political tensions or new opportunities for young democracies struggling to build genuine free-market societies. In recent decades, the central bank received help from its more prominent overseas counterparts when together they would try to synchronize monetary policy. But with the Bank of Japan focused on the crisis in Tokyo and Germany's Bundesbank preoccupied with the euro, the Fed now stands alone as the world's de facto central bank.
When the FOMC meets on Aug. 18, it is likely to keep rates steady, thanks to a slowing economy and a shaky stock market. But look for agonizing trade-offs as early as next month. If strong U.S. growth resumes, labor markets tighten, and the equity markets are reasonably steady, the Fed could be forced to raise rates. This would drive down the yen, provoke another round of devaluations throughout Asia, deepen the recessions from Seoul to Jakarta, and weaken Russia and Brazil.

A different scenario would arise if the U.S. economy continues to lose steam but wage inflation rises. Then the Fed might choose not to lower rates. That would endorse slower U.S. economic growth, which might be desirable--but ensure slower growth around the world, which would be dangerous.

No one advocates that the Fed should shirk its duty as guardian of domestic price stability. The question is more nuanced: Are there occasions when the Fed should set rates with an eye toward global stability, or even global growth, if that means a slightly different level from that required to meet the short-term needs of the U.S. economy?

WORLDVIEW. The answer is yes. America's interaction with other nations is now enormous. A third of its growth for most of the 1990s has come from exports, and a third of Treasury securities are bought by foreign investors. As the past few weeks have vividly demonstrated, conditions beyond U.S. shores are increasingly affecting corporate profits and stock prices. Lurking in the background also could be a rise in unemployment resulting from declining exports.

Is it possible to envision a Fed that is more sensitive to its impact on other nations and the boomerang effect on the U.S.? While it could make theoretical sense to modernize the central bank's charter to provide more international flexibility, no sane Administration would allow the current inward-looking Congress, which cannot even muster support for the International Monetary Fund, to try.

Members of the FOMC could help by construing their legal writ more broadly to take account of the feedback effect on the U.S. economy of what the Fed does to foreign countries. And more Fed governors and presidents of regional branches of the Fed could be selected for their international experience. At present, they are chosen according to much narrower
qualifications, such as measuring the domestic money supply, or their expertise in community investment. (The latter is what the Administration says it seeks in its next appointment for Fed governor.) Changes like these take time. But without them, a global debacle waits in the wings.

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