Greenspan's Successor Will Face More Global Issues (Update3)

Sept. 23 (Bloomberg) -- Alan Greenspan has been the most globally minded Federal Reserve chairman in history. His successor will have to be even more so.

Greenspan, whose term ends in January, today met fellow central bankers and finance ministers at the Group of Seven meeting in Washington. The Fed's next leader will inherit an economy more influenced than ever by foreign forces, complicating the task of setting U.S. interest rates.

``The Fed must keep its eyes open on the world economy because it's so darn important to our economy,'' said former Fed Governor Laurence Meyer, now vice chairman of Macroeconomic Advisors LLC in St. Louis. ``The world economy is now much more complicated, and that creates challenges for the next chairman.''

Among the possible challenges posed from overseas: Rising oil prices fanning inflation, the dollar being undermined by an unprecedented U.S. trade deficit, market interest rates set by foreign demand for U.S. government securities and the loss of American jobs to cheap labor markets in China and India.

The world economy swelled to $44 trillion from $17 trillion since Greenspan, 79, joined the Fed in 1987, with the U.S. accounting for a quarter of the total. China's economy is now the seventh largest in the world, eclipsing Canada. The Internet and the end of communism mean nations are now more intermingled: Workers in India can now perform tasks for companies in Indiana.

Greenspan has attended more G-7 meetings than any other central banker. The group is adding a meeting in London in December in part to mark Greenspan's retirement, a U.S. Treasury official told reporters on condition his name not be used.

`An Irritation'

Where once the central bank regarded international issues as an ``irritation, now the Fed needs to think about the rest of the world,'' said Ted Truman, a senior fellow at the Washington-based Institute for International Economics who ran the Fed's international finance division from 1977 to 1998.

Topics at today's G-7 meetings included the U.S. trade deficit, surging oil prices and the impact of economic expansion in China and India, all of which ultimately influence the outlook for U.S. interest rates.

``The global economy, as whole, continues to expand and the outlook is positive for further growth,'' the G-7 officials said in a statement at the end of their talks. ``However, higher energy prices, growing global imbalances and rising protectionist pressures have increased risks to the outlook.''

Imports and Jobs

Competition from China and India and their cheaper workforces will likely continue to hold down U.S. wages, restraining purchasing power and costing jobs, economists say. At the same time, inflation will be curbed by lower prices on American store shelves.

``This is a new environment,'' said David M. Jones, chief executive of DMJ Advisors, an investment consulting firm in Denver. ``These issues of globalization are going to be a really big issue for Greenspan's successor.''

Bentonville, Arkansas-based Wal-Mart Stores Inc., for example, imported some $18 billion of Chinese goods last year, making the world's largest retailer China's eighth-largest trading partner. Meanwhile, just 2.8 million jobs have been created in the U.S. since the last recession, below the pace of previous recoveries, in part as companies hire cheaper workers abroad.

Foreigners also now own almost half of the $4.6 trillion outstanding U.S. government securities, capping market interest rates and requiring the Fed to manage the economy in a way that makes them want to keep holding U.S. assets.

``We are massively reliant on foreign capital,'' said Robert Hormats, vice chairman at Goldman Sachs International in New York. ``One of the jobs of the next Fed chairman will be to keep investors confident in the economy.''

A Home-Price Boom

The resulting low bond yields, even after 15 months of Fed interest-rate increases, also fueled a boom in home prices that Greenspan has called unsustainable.

That's ``going to make the Fed move more than they would have to do otherwise,'' said Stephen Stanley, chief economist at RBS Greenwich Capital in Greenwich, Connecticut. The Fed this week raised its target rate for the 11th straight time since June 2004, to 3.75 percent, and Stanley said it may reach 5.5 percent under the next Fed chairman.

The trade deficit, $57.9 billion in July, may also become a major issue at today's meeting. Such a shortfall risks triggering a global recession and collapse in the dollar if unchecked, said Stephen Roach, chief economist at Morgan Stanley in New York.

``The case for a classic U.S. current account adjustment grows more compelling,'' Roach said in a Sept. 16 report. ``This could lead to renewed weakening of the dollar and higher long-term real interest rates.''

Oil's Challenge

The price of oil, up 43 percent in the past year, may turn out to be a bigger challenge for the next Fed chairman if the prices are sustained. While consumer prices rose 3.6 percent for the 12 months through August, they rose only 2.1 percent excluding food and energy, suggesting that the energy costs have not yet seeped through to other products.

The International Monetary Fund this week predicted oil will rise to an average $61.75 a barrel in 2006 from $54.23 this year. ``Higher oil prices are a clear and present danger'' to inflation and the confidence of consumers and companies, IMF Chief Economist Raghuram Rajan told reporters Sept. 21.

Greenspan's responses to the 1997 Asian financial crisis and 1998 Russian debt default prompted Time magazine to put him on its cover, along with Robert Rubin and Lawrence Summers of the Treasury Department, as part of a triumvirate it dubbed ``The Committee to Save the World.'' The Fed cut rates three times in that period, even though the U.S. economy was in the midst of a 10-year boom, its longest ever.

Fueling a Bubble

Greenspan took heat from critics who said the lower borrowing costs fueled the technology-stock price bubble that burst in 2000, said Alice Rivlin, the central bank's vice chairman from 1996 to 1999. Today, she said investors would expect the Fed to take action.

``The remarkable thing about the U.S. is that for so long we were so big, and we were not heavily engaged,'' said Rivlin, who is now a visiting professor of public policy at Georgetown University in Washington. ``We have to worry about global financial crises affecting our economy.''

The Fed chairman needs to be the ``guardian of global financial stability,'' said Nouriel Roubini, an economist at New York University and a former U.S. Treasury official.

A Good Citizen

``With globalization the Fed may be drawn, even more than in the past, to deal with systemic risk episodes,'' he said. ``We need a chairman of the Fed who fully understands global macro issues and the functioning of international capital markets.''

Today's international sensitivity is reflected throughout the Fed system. Each of the seven governors now monitors part of the globe: Donald Kohn, for example, follows the Pacific Rim. The 12 regional Fed bank presidents have established international research operations, such as the Dallas Fed's new project to study how the global labor market affects U.S. prices and wages.

Former Fed Vice Chairman Alan Blinder said the Fed should even sometimes shift interest rates to help economies elsewhere if doing so would have no adverse impact on the U.S.

``The U.S. economy is so large, and the Fed is so central to the global financial system, that the Fed's influence spreads well beyond our borders,'' Blinder, now a professor at Princeton University in New Jersey, said in a study co-written with Princeton colleague Ricardo Reis. ``Shouldn't the Fed therefore behave like a good citizen of the world?''

For his own part, Greenspan last month told the annual central banking retreat in Jackson Hole, Wyoming, that he's confident his replacement will meet the international challenges. ``I have little doubt that my successors, and theirs, will continue to sustain the leadership of the American financial system in an ever-widening global economy,'' he said.

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