Trump *and the* Independence *of the* Fed

Will the new President follow up on his campaign rhetoric?

By John M. Berry

Donald J. Trump's presidential victory has cast a dark cloud of uncertainty over the future independence of the Federal Reserve and especially its ability to protect the nation's financial system in any future crisis. The Republican-controlled House of Representatives has repeatedly passed legislation intended to force the nation's central bank to operate in a narrow, rules-based manner with a primary focus on fighting inflation even when inflation is not a threat. Other bills sought to undo many of the steps taken under the Dodd-Frank law to reduce the risk that failure of a large financial institution could endanger the financial system. None of the legislation made it through the Senate, and if any had, President Obama undoubtedly would have vetoed it.

Now the world has changed.

Late in the caustic campaign, Trump used an openly anti-Semitic television ad to attack Fed Chair Janet L. Yellen as being part of an international financial cabal of special interests supporting Hillary Clinton. He also repeatedly claimed that Yellen was "political" and that she was keeping interest rates low only to help Obama and Clinton. And like the House Republicans, Trump called for repeal of Dodd-Frank.

Yellen's four-year term as Fed chair ends early in 2018. A Trump adviser said the new president would not ask her to resign but would not reappoint her. Similarly, Fed Vice Chairman Stanley Fischer's term ends later that year.

John M. Berry has covered the economy for four decades for the Washington Post, *Bloomberg News, and other publications.*

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220 I Street, N.E., Suite 200
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Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

And there are already two vacancies on the seven-member Fed Board that Trump can fill.

In many ways, the attacks on the Fed have been bizarre. It used to be that politicians' loudest complaints about the Fed, often from members of both parties, came when the central bank was raising interest rates to cool off an overheated economy that was generating higher inflation—taking away the punch bowl just when the party gets going, as Fed Chairman William McChesney Martin famously put it more than half a century ago.

But in the wake of the financial crisis with Obama in the White House, something fundamental shifted: When the Fed pulled out all the stops to prevent the collapse of the U.S. financial system and bring down double-digit jobless rates, many conservatives criticized the central bank for using unconventional methods that, the critics claimed, would cause a horrendous inflation. The central bank must raise rates to head off that looming inflation and puncture expanding bubbles in asset prices, they insisted. Meanwhile, after one round of fiscal stimulus enacted while Democrats controlled Congress, conservatives demanded that federal spending also be slashed to reduce soaring budget deficits—the reverse of the normal response to a major economic slump. Then the Fed with its "misguided" policies got the blame for the slow, sometimes halting, recovery.

Smart Infrastructure Spending

Lawrence H. Summers:
Tax credits are inadequate.

Some liberal economists, such as Harvard professor and former Treasury Secretary Lawrence H. Summers, have argued for years that a well-crafted infrastructure program could possibly pay for itself in the long run by increasing productivity and raising potential economic growth.

After the election, Summers wrote in the *Financial Times* that debt-financed infrastructure investments while interest rates are so low make sense, and he welcomed Trump's move in that direction. However, he said, the plan offered by some advisers to use tax credits for equity investment won't do the job.

"Many of the highest return infrastructure investments—such as improving roads, repairing 60,000 structurally deficient bridges, upgrading schools or modernizing the air traffic control system—do not generate a commercial return and so are excluded from his plan. Nor can the non-taxable pension funds, endowments, and sovereign-wealth funds that are the most promising sources of capital for infrastructure takes advantage of the program," Summers wrote.

—J. Berry

What comes next is totally up in the air. Does Trump, a real estate developer, really want substantially higher interest rates? Yellen and most other officials on the Federal Open Market Committee were ready to raise their target for overnight interest rates by a quarter of a percentage point at their December meeting. A year ago, they did that after holding the rate effectively at zero for seven years.

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Yellen has resisted raising rates during the second half of this year because inflation has stayed below the Fed's annual inflation target of 2 percent, as measured by the personal consumption price index. And while unemployment has hovered at or just below 5 percent, which is close to many economists' estimate of full employment, strong demand for workers has caused a significant number of people who had not been seeking jobs to rejoin the work force—a development she has not wanted to short-circuit. Only recently has the rising demand for workers begun to show up in a more rapid increase in wages.

Financial markets quickly responded to Trump's election in an unexpectedly positive way. Instead of worrying about potentially disastrous actions such as slapping 45 percent tariffs on imports from China and 35 percent on those from Mexico, as he promised in the campaign, markets focused on another promise: economic stimulus in the form massive new government spending on infrastructure projects. Yellen, of course, has been urging such action for several years.

Congressional Republicans have refused to consider it, often on the grounds that such was the work of "big government" liberals, and with deficits still large they

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claimed it was not affordable. For instance, both the House and the Senate tied themselves in knots before finding a way just to pay for a new highway spending plan without raising the federal motor fuel tax, which was last increased twenty-three years ago.

Of course, now that there is a Republican president, concern about spending and big government might fall by the wayside—just as it did during much of the time George W. Bush was in the White House. In those years, deficits were ignored when tax cuts, a new prescription drug benefit for those on Medicare, and the cost of the wars in Afghanistan and Iraq were shrugged away. Trump, too, is proposing large additional tax cuts, mostly for those in upper-income brackets.

Shortly after the election, economists at Goldman Sachs assessed the uncertain mix of Trump's economic proposals: "The positive fiscal impulse from his tax reform and

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infrastructure proposals could provide a near-term boost to growth and, depending on the specifics, could have positive longer-run supply side effects. However, other proposals could lead to new restrictions on foreign trade and immigration, which could have negative implications for growth, particularly over the longer run," they told their clients.

The markets' response was a bounce in stock prices and a jump in yields on ten-year U.S. Treasury notes by more than half a percentage point—presumably in expectation of faster economic growth, higher inflation, and a Fed response in the form of more increases in the target for overnight rates. Stimulus itself is not likely to worry most Fed officials.

Yellen, Fischer, and others have said repeatedly that they would be much more comfortable if their overnight rate target were considerably higher. For one thing, if it were, and a recession hit, the central bank would be able to respond more strongly because it would have more room to cut rates to spur growth. In addition, Fischer said in a speech to the New York Economic Club in October, low long-term rates may be "a signal that the economy's long-run growth prospects are dim," and they "may also threaten

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financial stability as some investors reach for yield" and take on excessive risk, he said.

Actually, those same concerns are among the reasons that some Fed critics have been clamoring for rates to be raised. But officials have resisted because, in their view, the economy simply has not been strong enough to absorb such increases without bringing on the slump they want to avoid.

In the New York speech, Fischer explained that the equilibrium real interest rate—the inflation-adjusted rate of interest when the economy is at full employment and inflation is stable—has declined by roughly 3 percentage points in recent years. Several factors have contributed to the decline, he said, including slower growth of productivity, investment, population and the overall economy. So have a lower cost of capital and a lower level of foreign interest rates. In the face of this dramatic change, the Fed has had to keep overnight rates extremely low to help support even modest economic growth.

In fact, James Bullard, president of the St. Louis Federal Reserve Bank, said recently that, given the current level of the equilibrium real rate, the overnight rate target should be raised in December but not raised again for the next three years.

So what might reverse this drop in the equilibrium real rate of interest? Implicit in Fischer's analysis is that there

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really is nothing that the Fed itself can do. Its policies have helped a severely wounded economy get back on its feet. But something else is needed, possibly a fiscal stimulus including more investment in infrastructure and possibly tax cuts—if they "did not compromise long-run fiscal sustainability," he said.

In this world of super-low interest rates, some liberal economists, such as Harvard professor and former Treasury Secretary Lawrence H. Summers, have argued for years that a well-crafted infrastructure program could possibly pay for itself in the long run by increasing productivity and raising potential economic growth. Whether Trump's proposals would do this is far from clear. Certainly spending tens of billions of dollars on a wall on the Mexican border would do nothing to increase the nation's productivity.

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And if the infrastructure plan goal is to spur faster economic growth, cutting taxes on high-income individuals is not going to do much to boost consumer spending.

Even if some version of Trump's infrastructure schemes moves forward, the economic benefits could be offset by his other proposals. For instance, fear of what his animus for Mexico may produce, such as the 35 percent tariff, caused an overnight drop in the value of the peso. That immediately made that nation much less wealthy, and it made its workers that much more competitive with their American counterparts.

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Getting less attention at the moment but potentially more dangerous is the strong effort by House Republicans to gut the Dodd-Frank law. Almost every facet of Dodd-Frank has been under attack, including most of the efforts by the Fed, the Federal Deposit Insurance Corporation, and other regulators to make large financial institutions less of a risk to the financial system.

In effect, the legislators want to curtail the regulators' freedom to act while giving Congress more ways to influence their decisions. For example, they want Fed spending on regulatory activity to be subject to congressional appropriation authority rather than continue to be financed from central bank profits from supplying the nation with currency. And any agency headed by a single person, such as the Office of the Comptroller of the Currency, which regulates many nationally chartered banks, and the Commodity Futures Trading Commission, would in the future by run by a bipartisan commission.

Most of all, they are determined to limit the central bank's ability to serve as a lender of last resort. In a reaction to the bank bailouts during the financial crisis, that classic power of central banks was significantly curtailed. The House conservatives want to tighten those restrictions much further.

Trump has made it plain he wants to curb many aspects of federal regulation of a wide range of activities. How far he will go—or how far he will let congressional conservatives go—is impossible to tell.

The same has to be said of most of what he may propose that will affect the broader economy.

For now, the Fed can only continue to make its monetary policy decisions in response to what the data show is happening economically here and in the rest of the world. Meanwhile, it undoubtedly will do its best to remain probably the least political entity in the U.S. government. ◆