Insight

Trump Escalates Attack on Federal Reserve

THOMAS KINGSLEY | AUGUST 21, 2018

Executive Summary

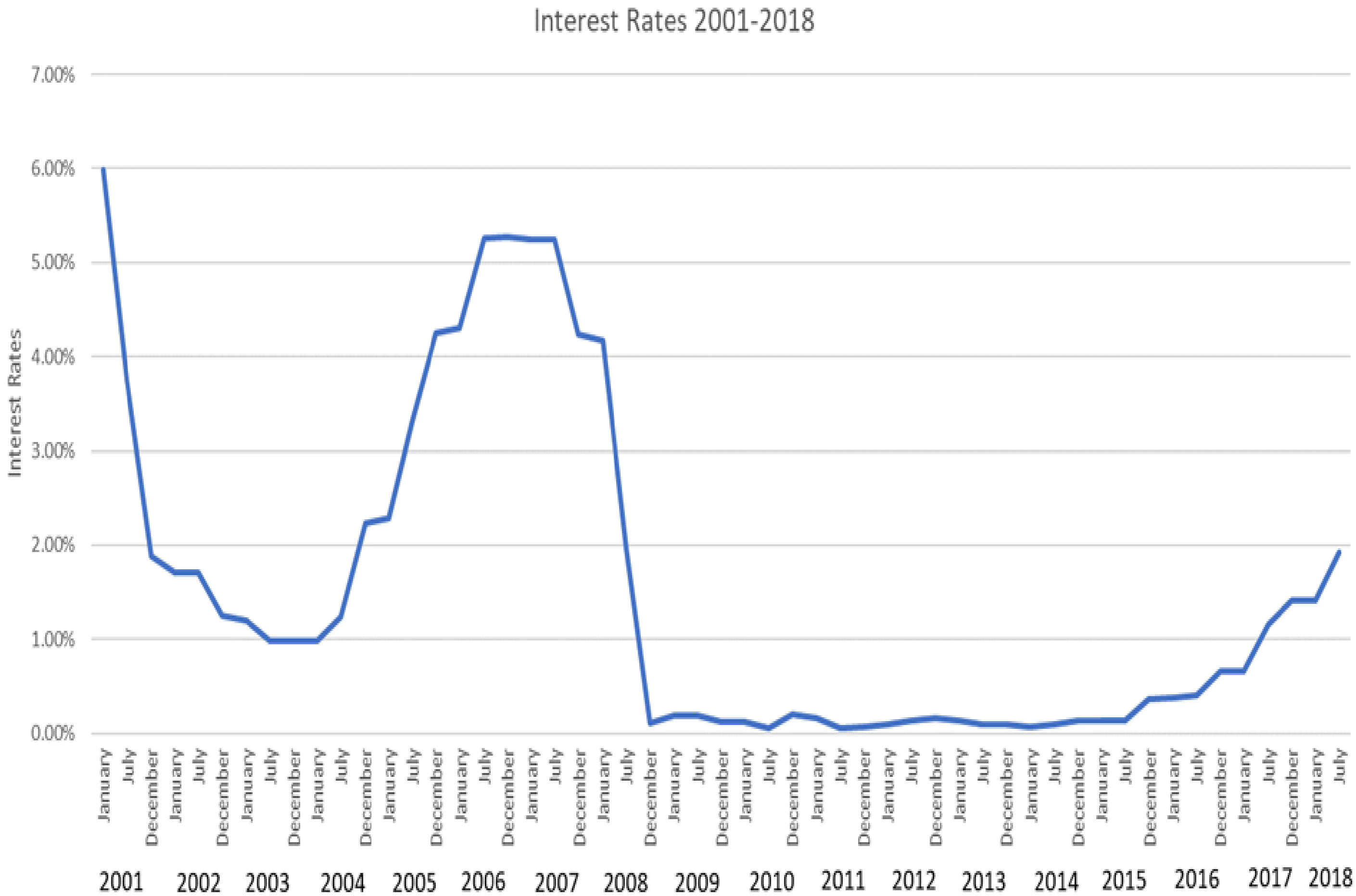
- President Trump has shown a willingness unprecedented in recent years to criticize the work of the Federal Reserve and the Federal Reserve Chairman.
- The independence of the Federal Reserve is vital to the functioning of a healthy economy.
- Trump's remarks risk destabilizing macroeconomic policy and could have severe adverse impacts on inflation and employment.

Context

In the United States, interest rates are based on the federal funds rate, which the Federal Reserve (the Fed) sets. As interest rates decrease, the cost of borrowing decreases, typically leading to more capital in the market with increased spending and investment, and – in theory – a growing economy. As the economy grows, so usually does inflation, which represents the increase in prices for the same goods and services. Conversely, higher interest rates typically promote the reverse: Rather than spend, market participants save, as their rate of return is higher, and as a result the economy contracts and inflation decreases.

Inflation impacts the purchasing power of money, and sustained periods of inflation represent a real fear for policy makers – and not just a theoretical or historical concern. In Venezuela at the moment, the price of a chicken is fourteen million bolivars, and the International Monetary Fund anticipates prices will increase 1 million percent in Venezuela this year. Determining the "ideal" or most "effective" rate of inflation is therefore a fine art, and one of the most complex and crucial functions of the Fed. Conventional wisdom in the United States, as represented by the Federal Reserve's Federal Open Market Committee (FOMC), is that a 2 percent inflation rate is the ideal nexus of economic growth and maximum employment – a target shared, for instance, by the Bank of England. Some inflation is always desirable, not least because it allows the Fed to manage economic "bumps" through the judicious use of monetary policy.

Since the appointment of Fed Chairman Jerome Powell in February, the Fed has hiked rates twice and a further hike is anticipated next month. The current rate fluctuates between 1.75 and 2 percent, compared to 1.25 percent a year ago. These rates are low relative to rates over the last two decades, as can be seen in the graph below.



Source: https://www.macrotrends.net/2015/fed-funds-rate-historical-chart

As the U.S. economy is in a sustained period of economic growth, the Fed is anticipated to continue to raise interest rates through this year and next to safeguard against the economy "overheating." Meanwhile, President Trump appears to be putting his thumb on the scales of this delicate balancing act, if not risking tipping over the scales entirely.

Even before his election President Trump had shown a surprising degree of antipathy towards the Fed. During his campaign Trump reproached the Fed for keeping interest rates low to artificially prop up the economy. Since appointment, however, Trump has advocated for lower rates and shown a surprising willingness to comment on the Fed and Jerome Powell's decisions directly. This week Trump criticized the Fed in an interview with Reuters for raising interest rates too quickly and not doing enough to boost the U.S. economy. In the same interview, Trump also suggested that China and the European Union are actively devaluing their currency in response to U.S. tariffs. What this critique fails to recognize is that by imposing tariffs on imports, the United States is contributing to the devaluation of both the yuan and the euro by decreasing foreign income and shifting investors away from those nations. It is also curious to note that, as appears to be the new standard in this administration, in less than a year Trump has moved from praising his appointment Powell's "wisdom" and "leadership" to questioning his activities as Chairman of the Fed. The U.S. dollar immediately fell on Trump's comments to Reuters.

Why does all this matter? The importance of the Fed's independence has been conventional wisdom since the early 1980s. Not that all previous Presidents have resisted the urge to apply pressure to the Fed – all Presidents face the temptation to 'control' or at least 'guide' economic growth and unemployment. The most notable example in recent history was that of President Nixon's. In the run-up to the 1972 presidential election, President Nixon pressured the Fed to keep interest rates low; the resulting impact on prices required Fed Chairman Paul Volcker to raise interest rates as high as 20 percent to combat inflation. Suddenly the path to million-dollar chickens becomes clear. Volcker is credited with demanding of first President Carter and then President Reagan an autonomous and independent central bank. Trump's remarks break a fifty-year taboo against direct remarks from a sitting President on the Fed and the Fed Chairman.

Putting aside the substantive merit of Trump's comments, it is worth noting that by simply making his remarks at all the President imperils the smooth operation of the Fed. As former Fed Chairman Ben Bernanke remarked, "Careful empirical studies support the view that more-independent central banks tend to deliver better inflation outcomes than less-independent central banks, without compromising economic growth." The data appear clear, and that conclusion is supported by common sense. The Fed is dealing in enormously complex, long-term macroeconomic theory, and its decisions should not be influenced, let alone determined, by any one individual outside the Fed.

Conclusions

Sound monetary policy – which may seek to effect change over decades – must be insulated from political concerns, which is often driven by the 24-hour news cycle. The received wisdom is that it can take at least twelve months before it is even possible to measure the impacts of changes to interest rates. Trump's interference with the work of the Fed – much like Trump's tariffs – may have the opposite of the desired effect. Although the economy may receive a short-term boost, an artificially low interest rate typically will depress the value of the dollar. Low interest rates are not compatible with Trump's assertion that the economy is going from strength to strength, and Trump's remarks in and of themselves will likely hurt the economy.