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Featured G

Waging War on the Fed — the Opening Salvo

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It was inevitable that President Donald Trump would comment on U.S. monetary policy.
The president has shown little regard for precedent or institutional norms if he sees them as obstructions on the path to realizing a goal. The Trump administration wants to fire things up: animal spirits, productivity, and economic growth. The Federal Reserve (Fed) is leaning the other way. Dress it up anyway you want but the goal of the rate hikes is to slow things down in order to prevent the economy from exceeding its potential and overheating.

What the president said to CNBC's news anchor Joe Kernen in his July 20 interview was, *"I'm not thrilled because every time we go up they want to raise rates and I am not happy about it."*

The gush of commentary that has followed has focused on the implication for Fed independence. Most conclude that the Fed has faced White House pressure before and will stand up for itself again. And Treasury Secretary Steve Mnuchin did officially reaffirm the Fed's independence only a few days after the president's interview.

No one can say how this latest White House challenge to the Fed will evolve.

It seems unlikely that interference will go as far as the situation in Japan, where the Bank of Japan (BoJ) has effectively become a vassal of the government. Prime Minister Shinzo Abe campaigned in 2012 on a platform that included getting rid of the incumbent BoJ chairman, and embarked on a radical plan to end Japan's deflation. Six years later and with the BoJ's balance sheet near 100% of gross domestic product (GDP), the central bank has been forced to extend its unorthodoxy indefinitely, even with the Japanese economy expanding steadily and wage growth finally emerging. A small rise in interest rates has enormous fiscal implications with government debt at 250% of GDP. History may determine that the government was correct to coerce the central bank into its current position, but in the interim, the BoJ seems to have lost its independence.

But President Trump's rebuke of domestic monetary policy was no off-the-cuff remark. It had been foreshadowed several times this year by similar critical comments from two administration officials: Larry Kudlow, Director of the White House National Economic Council, and Peter Navarro, Trump's trade advisor. A third, Mick Mulvaney, the White House Budget Director, went to bat defending the president's criticism of the Fed the day after he made his remarks.

At the heart of the White House dispute with the Fed is a fundamental disagreement between the supply-side architects of the administration's growth strategy and the neoclassical economists who dominate the Fed and the economic establishment of the country.

Most mainstream economists believe that economic growth oscillates above and below a line of potential GDP, the latter determined by the growth rate of the workforce and productivity. Productivity is a by-product of innovation and technological discovery and largely exogenous of macro forces, or so the neoclassical thinking goes. For that reason most economic outlooks incorporate extrapolations of past productivity trends into the future. Productivity has been quite low over the past several years and most mainstream economists believe it will stay low. Robert Gordon's treatise on failing innovation offers the most detailed analysis on the topic; weak productivity lies at the core of the secular stagnation thesis championed by Larry Summers.

So it is largely from this perspective that the Fed's long-term economic projections show GDP growth converging to a trajectory of slightly less than 2%. By that standard, the current level of output is already close to or above this trajectory and the economy is growing unsustainably fast. Waiting to raise rates any longer only increases the odds of overheating and increases the downside of the eventual reversion back to trend. On top of all this, the enormous fiscal stimulus of the Trump budget at this stage of the expansion has left economists bug-eyed by the budget deficit projections. They are unprecedented for this stage of the cycle and double

anywhere else in the Organization for Economic Cooperation and Development. Many look at this stimulus as a form of Keynesian pump priming. It is no surprise that Fed Chair Jerome Powell is more confident about the outlook than his predecessor—he has every reason to be.

The conventional perspective drives the supply siders in the White House crazy. Supply-side theory argues that growth drives productivity, not the other way around. Productivity is endogenous to the pace of expansion and stems directly from net expansions to the capital stock of a nation, is the argument. Correspondingly, the administration's policy of corporate tax cuts is designed specifically to encourage business investment, which will boost the capital stock, and ultimately, productivity. The eye-popping budget deficits won't happen if the Fed gives the growth process a chance, especially since inflation remains low.

There is some academic research to support the White House view and it is provided by the Fed itself. Two Fed staff economists in a working paper document how tax cuts in the post-1980s era have been associated with lower equity returns in spite of higher cash flows because of the effect on discount rates caused by a more restrictive Fed. This is still not hard counter-factual evidence but it does suggest that Fed reactions to fiscal stimulus have tended to smother the beneficial growth effects of past stimulative measures.

The policy debate is hardly academic. The threat of the Fed robbing the administration of success is a movie that many of the supply siders in the White House believe they have seen before. Kudlow and other supply siders believe it was the hard money attitude of the Volcker Fed and the resulting surge in the U.S. dollar during the Reagan era that undermined the potential growth path of U.S. GDP and led to the yawning deficits of that era instead of better productivity and faster non-inflationary growth.

President Trump seems wary of this mechanism playing out again.

"I don't like all this work that goes into what we are doing…you look at the euro, you look at what is going on with the EU…they are not doing what we are doing…and we already have somewhat of a disadvantage…last year and for years we have been losing $150 billion with EU nations…they are making money easy and their currency is falling and China their currency is dropping like a rock and our currency is going up and I have to tell you it puts us at a disadvantage… I don't like all this work we are putting into this economy and then I see rates going up."

One thing is for sure. President Trump is never shy to express his displeasure. Sustaining rapid economic growth is the foundation of his presidency. Any action that undermines this outcome will get his attention and incur his wrath. Many variables seem to have reached a crucial fork in the road. Nominal GDP growth broke out above post-2008 highs for the first time in the second quarter. The Fed has sounded more hawkish all year and the speed of balance sheet tightening is picking up. In the meantime, the dollar is at a significant level. Whatever the future of Fed independence, Trump's recent criticism was probably just the opening salvo.

Diercks, Anthony M. and Waller, William, Taxes and the Fed: Theory and Evidence from Equities (2017-10-11). FEDS Working Paper No. 2017-104. Available at SSRN: https://ssrn.com/abstract=3052177 or http://dx.doi.org/10.17016/FEDS.2017.104

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