Project Syndicate

The Perils of a Trumped Fed

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ITHACA – While he attempts to overhaul American tax, trade, and immigration policies, President Donald Trump is mulling over a set of decisions that could prove even more consequential for the US economy. With Federal Reserve Vice Chair Stanley Fischer having retired this month, three of the seven seats on the Fed Board of Governors are now vacant. And in February 2018, Fed Chair Janet Yellen's first term will end, giving Trump a unique opportunity to stamp his brand on the institution.

Trump's nominees to fill these positions, and how he goes about choosing them, could have an enduring impact not just on the Fed, but also on the US economy and its central position in the global financial system.

The Fed's credibility has been methodically and painstakingly established over the course of many decades. A case in point is former Fed Chair Paul Volcker's decision, in the early 1980s, to hike interest rates and accept a temporary increase in unemployment. Had Volcker not acted, the US would have suffered from spiraling inflation. Volcker's move induced the short-term pain; but it also bolstered the Fed's long-term credibility.

Inflation is driven by many factors that the Fed cannot control, including productivity, foreign prices, and government deficits. But expectations about the future can also play a key role. When firms and workers think the Fed is not committed to holding down inflation, inflation tends to rise.

The same is true for deflation. At first blush, falling prices for goods and services may sound like a good thing. But deflation can be disastrous. When prices are expected to fall, consumers will hold off on making purchases, and businesses will postpone investments. These decisions can then create a vicious cycle in which falling demand leads to reduced employment, growth, and prices, causing demand to fall further.

After the 2008 global financial crisis, many countries faced the specter of deflation. But, thanks to the Fed, the US avoided both severe deflation and inflation, and

recovered faster than most other advanced economies. The Fed managed to ward off deflation in the US by aggressively loosening monetary policy. At the time, many economists feared that a rapidly expanding money supply and sharply rising government debt would fuel inflation and weaken the dollar. But these fears proved unfounded, and the Fed's credibility was bolstered once again.
The Fed's credibility is what underpins the US dollar's dominance in international finance. About two-thirds of global central banks' foreign-exchange reserves – that is to say, their rainy-day funds – are invested in dollars. And foreign investors, including central banks, hold more than $6 trillion in US government securities, up from $3 trillion a decade ago. The dollar's status as the main global reserve currency has helped to keep US interest rates low, thus reducing borrowing costs for US consumers and the US government.

The Fed's independence, along with the US's institutionalized system of checks and balances and its adherence to the rule of law, is crucial for sustaining investors' confidence in the dollar. Yet the Trump administration is weakening the checks and balances between the executive and legislative branches of government, and his indifference to the rule of law could pose a direct challenge to the judicial branch. Under these circumstances, any act that undermines the Fed's independence could seriously damage the institutional framework upon which US economic strength rests.

The Fed has international credibility precisely because it is independent from any political master. But the Fed also has legitimacy, because it is accountable to the government and to the people. That accountability is, or at least should be, based on pre-established economic targets – namely, low inflation and unemployment – rather than on the political whims of whoever is in power at a given moment.

From this perspective, Trump could seriously damage the Fed's credibility. He need only appoint political loyalists instead of the best available technocrats; or appoint competent technocrats whom he has cajoled into professing personal loyalty to him, rather than to their mandates as Fed governors.

A Fed dominated by Trump acolytes might prioritize economic growth over other objectives, such as maintaining financial stability and low inflation. But while this approach may boost GDP growth for a brief period, it would hurt growth in the long run, by fueling inflation and financial-market instability.

Another danger is that Trump will get his wish for a weaker dollar – permanently. Even the mere possibility of reduced faith in the dollar, alongside higher inflation, could push up interest rates, leading to larger budget deficits, lower growth, and an inflationary spiral.

If Trump does try to press the Fed into the service of his own political agenda, he could do irreparable harm to an institution that ensures financial stability, low and stable inflation, and sustainable growth. Rather than putting “America first,” he would be undercutting the dollar’s status as the dominant global reserve currency, and clearing the way for others to fill its role in global financial markets.

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