Former Fed official calls on central bank to end accommodation to Trump

By Nick Beams
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For weeks, the US Federal Reserve has been at the centre of political conflict. President Donald Trump has issued regular tweets attacking its refusal, so far, to meet his demand for major cuts in interest rates and a resumption of "quantitative easing" to boost share markets and put downward pressure on the US dollar.

Last week, Trump posed the question of who was the "bigger enemy" of the US, Fed chair Jerome Powell or China's President Xi Jinping. This week, he charged that the Fed was "mentally" unfit to assist the US in gaining a competitive edge in global markets. Its interest rate was too high, and other leaders at the recent G7 meeting were "giddy" about how low their interest rates had gone.

In another tweet, Trump said the Fed "loves watching our manufacturers struggle with their exports to the benefit of other parts of the world. Has anyone looked at what almost all other countries are doing to take advantage of the good old USA? Our Fed has been calling it wrong for too long!"

There has been something of a shift in the tone of Trump's attacks. Earlier, he had focused on the stock market—saying the Dow would rise by 10,000 points if the Fed cut rates. But more recent comments have pointed to the effect of Fed policy in maintaining a high dollar value, to the alleged disadvantage of the US.

This conflict reflects growing indications that the global economy is moving into recession and the consequent intensification of the struggle for markets between the rival capitalist powers. Already, the tariff and economic war launched by Washington against China is having a serious worldwide impact.

So far, the Democrats have opposed Trump on the basis that Fed should remain independent and not be subject to directives from the president. Now there are signs that attitudes may be changing, at least in some quarters.

This week, Bill Dudley published an opinion piece on Bloomberg directly calling on the Fed to oppose Trump. Dudley, a registered Democrat, served as president of the New York Federal Reserve from 2009 to 2018 and was vice-chairman of policy-making Federal Open Market Committee.

The conventional wisdom, Dudley wrote, was that the Fed took action to pursue the goal of stable prices and maximum employment. So, if Trump's trade war with China worsened the economic outlook by damaging business and consumer confidence, the Fed should cut rates.

"But what if the Fed's accommodation encourages the president to escalate the trade war further, increasing the risk of recession?" Dudley asked. "The central bank's efforts to cushion the blow might not merely be ineffectual. They might actually make things worse."

Dudley said Fed chair Powell was aware of the problem, pointing out that in Powell's address to the recent annual conference of central bankers at Jackson Hole he said "monetary policy could not provide a settled rulebook for international trade."

"Yet the Fed could go much further," Dudley wrote. "Officials could state explicitly that the central bank won't bail out an administration that keeps making bad choices on trade policy, making it abundantly clear that Trump will own the consequences of his actions."

Dudley said such a harder line would discourage further escalation of the trade war, reassert the Fed's independence from the administration's policies and conserve much-needed ammunition, when interest rates are already very low by historical standards.

"I understand and support Fed officials' desire to remain apolitical. But Trump's attacks on Powell and the institution have made that untenable. Central bank officials face a choice: enable the Trump administration to continue down a disastrous path of trade war escalation, or send a clear signal that if the administration does so, the president, not the Fed will bear the risks—including the risk of losing the next election."

Dudley concluded with an observation that conceivably the election itself fell within the Fed's purview. That was because Trump's re-election "arguably presents a threat to the US and global economy, to the Fed's independence and its ability to achieve its employment and inflation objectives."

If the goal of monetary policy were to achieve the best long-term economic outcome, "then Fed officials should consider how their decisions will affect the political outcome in 2020."

This was an extraordinary intervention. Former Fed officials generally confine their remarks to the state of the economy, but avoid discussing specific Fed decisions, let alone calling for it to act politically.

The central bank felt compelled to issue a statement reasserting its political independence. "The Federal Reserve's policy decisions are guided solely by its congressional mandate to maintain price stability and maximum employment. Political considerations play absolutely no role," Fed spokesperson Michelle Smith said.

The *Wall Street Journal* weighed in with an editorial, saying Dudley's opinion piece confirmed "that he views the Fed as an agent of the Democratic Party." His intervention would not help Powell "navigate monetary policy in a tricky political moment." It would "damage the Fed's ability to rally Congress and the business community to its defense."

Dudley would have been aware that his comments would be strongly opposed. The fact that he decided to go ahead anyway is an indication of the growing tensions within the political establishment, fuelled by increasing fears that, notwithstanding the claims of growth and near-record stock market highs, the US economy is heading for a recession.

This week the US bond market gave its clearest signal of such a prospect. Earlier this week, yields on two-year Treasury notes were 5.3 basis points higher than those on the 10-year government bond. Normally it is other way around. The inversion of the yield curve is regarded as one of the surest indicators of a recession. The inversion is now at its widest level since March 2007 in the lead-up to the 2008 financial crisis.

One of the most significant developments of the year has been the growth of negative yielding bonds—if an investor held them to maturity they would make a loss. The level of such bonds has doubled since the start of the year and now tops $16 trillion, or one third of the global bond market.

This phenomenon, unprecedented in economic history, is an indication of a global deflationary environment and the rising probability of a major slump.

In a comment issued last weekend, reported in the *Financial Times*, former US Treasury Secretary Larry Summers wrote: "Black-hole economics—interest rates stuck at zero with no real prospect of escape—is now the confident market expectation in Europe and Japan, with essentially zero or negative yields over a generation. The United States is only one recession away from joining them."