Donald Trump's Federal Reserve

Kenneth Rogoff | Harvard University | 03 November 2017

With the appointment of Jerome Powell as the next Chair of the United States Federal Reserve Board, Donald Trump has made perhaps the most important single decision of his presidency. It is a sane and sober choice that heralds short-term continuity in Fed interest-rate policy and, perhaps, a simpler and cleaner approach to regulatory policy.

Although Powell is not a PhD economist like current Fed Chair Janet Yellen and her predecessor, Ben Bernanke, he has used his years as an "ordinary" governor at the Fed to gain a deep knowledge of the key issues he will face. But make no mistake - the institution Powell will now head rules the global financial system. All other central bankers, finance ministers, and even presidents run a distant second.

If that seems hyperbolic, it is only because most of us don't really pay attention to the Fed on a day-to-day basis. When the Fed gets it right, price stability reigns, unemployment remains low, and output hums along. But "getting it right" is not always easy, and when the Fed gets it wrong, the results can be pretty ugly.

Famously, the Fed's efforts to tame a stock-market bubble in the late 1920s sparked the Great Depression of the 1930s. (Fortunately, of the candidates Trump was considering for the Fed post, Powell is the one least likely to repeat this mistake.) And, when the Fed printed mountains of money in the 1970s to try to dull the pain of that decade's oil shocks, it triggered an inflationary surge that took more than a decade to tame.

At times, the rest of the world seems to care more about Fed policy than Americans do. Little wonder - perhaps more than ever, the US dollar lies at the heart of the global financial system. This is partly because much of world trade and finance is indexed to the dollar, leading many countries to try to mimic Fed policies to stabilise their exchange rates.

Powell will face some extraordinary challenges at the outset of his five-year term. By some measures, stock markets look even frothier today than they did in the 1920s. With today's extraordinarily low interest rates, investors seem ever more willing to assume greater risk in search of return.

At the same time, despite a strongly growing US and global economy, inflation remains mystifyingly low. This has made it extremely difficult for the Fed to normalise policy interest rates (still only 1%) so that it has room to cut them when the next recession hits, which it inevitably will. (The odds of a recession hitting in any given year are around 17%, and that seems like a good guess now.)

If Powell and the Fed cannot normalise interest rates before the next recession, what will they do? Yellen insists that there is nothing to worry about; the Fed has everything under control, because it can turn to alternative instruments. But many economists have come to believe that much of this is smoke and mirrors.

For example, so-called quantitative easing involves having the Fed issue short-term debt to buy up long-term government debt. But the US Treasury owns the Fed, and can carry out such debt purchases perfectly well by itself.

Some argue for "helicopter money" whereby the Fed prints money and hands it out. But this, too, is smoke and mirrors. The Fed has neither the legal authority nor the political mandate to run fiscal policy. If it tries to do so, it runs the risk of forever losing its independence.

Given that monetary policy is the first and best line of defense against a recession, an urgent task for the new chair is to develop a better approach. Fortunately, good ideas exist, and one can only hope that Powell will quickly move to create a committee to study long-term fixes.

One idea is to raise the Fed's inflation target. But this would be problematic, not least because it would breach a decades-long promise to keep inflation around 2%. Moreover, higher inflation would induce greater indexation, ultimately undermining the effectiveness of monetary policy. Paving the way for effective negative-interest-rate policy is a more radical - but by far the more elegant - solution.

Bank regulation is also part of the Fed's mandate. The 2010 Dodd-Frank financial-reform legislation, which has spawned 30,000 pages of rules, has been a boon for lawyers. But the massive compliance costs ultimately fall on small and medium-size businesses. It would be far better simply to require banks to raise much more of their resources in equity markets instead of through bonds. That way, shareholders, not taxpayers, would take the big hit in a crisis.

I have not mentioned the elephant in the room - the threat to the Fed's independence posed by a president seemingly intent on challenging all institutional norms. When President Richard Nixon was intent on being re-elected in 1972, he put heavy pressure on then-Fed Chair Arthur Burns to "juice" the economy. Nixon was re-elected, but inflation soared and growth collapsed. No one should be wishing for a replay - even if Nixon eventually was impeached.

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