Jerome Powell's dilemma

By Carmen M. Reinhart and Vincent Reinhart

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There is a reason that the US Federal Reserve chair often has a haunted look. Probably to his deep and never-to-be-expressed frustration, the Fed is setting monetary policy in a way that increases the likelihood that President Donald Trump will be reelected next year.

Once a year, the leadership of both the European Central Bank and the United States Federal Reserve go to the mountains for policy enlightenment. The ECB conducts a forum every June in Sintra, a town in the foothills of the eponymous Portuguese mountain range. And the Fed convenes in late August in Jackson Hole, Wyoming, for the Kansas City branch's economic symposium. In retrospect, this year's remarks from on high by ECB President Mario Draghi and Fed Chair Jerome Powell provide insight into the global outlook and the two banks' recent policy actions, which have been coincident, but not coordinated.

In Jackson Hole, Powell named the challenge to the global economic outlook, not personally (US President Donald Trump), but operationally: heightened trade uncertainty, he said, presented a new drag on aggregate demand. Back in 2018, most Fed officials believed that 3% annual real GDP growth was unsustainable, because resource utilization was already taut. That assessment led the Fed to hike the policy interest rate by a quarter point four times.

That episode demonstrates the pitfalls of real-time policymaking. One year later, the Bureau of Economic Analysis trimmed almost half a percentage point from GDP growth for 2018, and the Bureau of Labor Statistics revised downward its estimate of monthly employment gains. Among the mechanisms by which an increase in interest rates slows aggregate demand is the foreign-exchange market. When the Fed is set on tightening as other central banks hug the effective lower bound of their nominal policy rates, the dollar's value rises. Essentially, dollar appreciation is a channel through which policymakers "donate" domestic economic strength to US trading partners that now have weaker, more attractive currencies. With the ECB's policy rate distinctly negative and its asset-purchase program running out of steam, Draghi especially appreciated the gift of easier European financial conditions last year.

Of course, the transfer of domestic economic strength by an independent agency, the Fed, displeased the chief executive, and withering criticism ensued. But it was not Trump's carping about dollar appreciation that led the Fed to change course. Rather, Trump's trade policies elevated uncertainty about investment and growth. Investment in long-term capital is always risky for a business. When doubt about such an investment emerges before concrete is poured, less concrete will be poured.

By early 2019, the Fed viewed this new economic headwind as obviating the need to continue raising the federal funds rate. As the year unfolded and the trade winds intensified, Fed officials switched course and began to ease policy.

Some economic mechanisms, however, are asymmetric. When the Fed tightens its policy, other central banks do not always follow, preferring to allow their currencies to depreciate. In contrast, when the Fed eases its policy, far fewer international partners are willing to let their currencies appreciate so that the dollar can depreciate. No one volunteers because everyone fears upward exchange-rate pressure. An earlier generation of central bankers would have relied on direct intervention in the currency market to pursue the same goal. But while this is still done in emerging-market economies, the use of reserves by an advanced economy would draw its peers' opprobrium. Instead, they achieve the same end by changing policy interest rates to deflect appreciation and welcome modest depreciation.

As a consequence, when the Fed pivoted, all other major central banks followed. Draghi pushed the ECB in that direction in Sintra and followed through with further easing on September 12. This similarly drew Trump's ire, as he viewed the move as directed toward the exchange rate. He is right, indirectly. A weaker euro is the intermediate result Draghi seeks in order to support a flagging economy and move inflation up to the ECB's target of near, but below, 2%.

The ECB's response, of course, means less dollar depreciation, weakening the stimulus effect of the Fed's move. And the consolation that by easing policy, the Fed single-handedly induced worldwide monetary accommodation does not get much credit from the White House. Trump would prefer that Powell were faster than his counterparts in the race to the interest-rate bottom. Powell's problem is that the US economy apparently does not require such stimulus. Job gains remain robust, and wages are ticking up. Global trade may be in recession, but the US economy is not as dependent as its trading partners on global trade.

Probably to Powell's deep and never-to-be-expressed frustration, the Fed is setting monetary policy in a way that increases the likelihood that Trump will be reelected next year. That instruction is not contained in the Federal Reserve Act, of course, but the Fed is supposed to deliver maximum employment and stable prices. Its mandate of sustainable economic growth thus requires Powell to attempt to offset the effects of policy uncertainty under Trump.

Fed officials are not thinking of intentionally letting the economy stumble between now and the 2020 election. Thus, if Powell succeeds, Trump will not bear the cost of his words and actions. This will invite more of the same.

There is a reason that Powell often has a haunted look, and not just at Jackson Hole.

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