Yellen's Swan Song

The U.S. economy is in good shape.

By John M. Berry

For the Federal Reserve, the world is almost always an uncertain place. Economic forecasts involve so many variables beyond the central bank's control that they often turn out to be well off the mark. Even the huge financial crisis that ultimately involved almost every corner of the globe struck with little warning, as Fed officials remember all too well. But this year's degree of uncertainly is unique: No American president has ever behaved like Donald J. Trump.

Essentially every aspect of government policy is up in the air as a result of Trump's capricious, often ill-informed pronouncements. Yes, Trump plans to propose large tax cuts, but what kind and who will benefit? Yes, some large spending increases might be put on the table, but there has been no concrete sign of the $1 trillion infrastructure promise he once made. He wants to spend much more on the military, while small-government advocates such as his budget director or Republican members of Congress push for significant spending cuts as well. Will Trump provoke trade wars with China, Mexico, Canada, or perhaps even the European Union? He has threatened to do so. How far will he and his cabinet and sub-cabinet appointees go to roll back regulation of business and financial market activities and environmental protections? And might his sweeping effort to restrict immigration and deport hundreds of thousands of people in this country illegally disrupt economic activity on a broad scale?

Obviously no one knows the answers, certainly not Fed Chair Janet L. Yellen and her policymaking colleagues. As New York Federal Reserve

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Six Million Jobs

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Fed Chair **Janet Yellen**

Bank President William Dudley quipped recently, "On fiscal policy stimulus, it's really hard to factor into your forecast at this point because we don't know what it is, how big it is, or when it will happen. Other than that, we have it completely nailed down." Fortunately, however, Fed officials are extremely well-positioned to deal with whatever Trump and the Republican-controlled House and Senate ultimately agree to put in place.

First of all, the U.S. economy is in very good shape, far better shape than the "disaster" claimed by the new president. It has grown relatively slowly ever since the crisis, but by the end of last year, total economic output was about 13 percent greater than it was in 2008 and the unemployment rate is back below 5 percent. The labor force participation rate is still down from its pre-crisis level, but nearly six million more workers have jobs than did then. As Yellen said in her semi-annual monetary policy report to Congress in mid-February, the economy is close to the "maximum employment" goal set by Congress—that is, the lowest level consistent over time with stable inflation. At the same time, consumer price inflation has moved up close to the 2 percent target the Fed has set as meeting the "stable prices" portion of the congressional mandate.

A 3.25 percent growth assumption looks like another of the Trump Administration's "alternative" facts.

The current debate among Fed policymakers, therefore, is not about what to do to fix some serious problems in the economy, but rather how to maintain what has been achieved. A majority of the policy-setting Federal Open Market Committee has agreed that the best course is a very gradual increase in the target for overnight interest rates. That target had been held close to zero for seven years before it was raised by a quarter-percentage point in December 2015. It was boosted by another quarter point last December to a range of 0.50 to 0.75 percent and again in mid-March to 0.75 to 1.0 percent. Nine of the seventeen participants expect two more quarter-point increases this year and four would like to see three. There's more diversity for 2018, but again two or three increases is the apparent preference. Easy does it so long as jobs and inflation remain on track.

The key reason for raising overnight rates at this point, Yellen has explained, is to very gradually withdraw the economic stimulus provided by the still very low target in hopes that job growth will continue while inflation levels off close to the 2 percent goal. Officials want to be sure inflation does not overshoot enough to force more rapid rate hikes that could tip the economy into a new slump. A secondary objective is to have a target level far enough above zero—what officials call the "effective lower bound"—that if some development caused economic growth to weaken noticeably, the Fed could counter by cutting rates once more. Right now, with the target only half a percentage point above that lower bound there is hardly any room to cut.

All in all, it is a relatively delicate balancing act.

Trump, of course, has declared that the U.S. economy can and should grow faster and provide more jobs. To that end, he has promised to cut taxes, increase spending, and reduce federal regulations, all of which he claims would spur growth to a 3.5 percent or greater pace. Immediately after he was elected, investors apparently believed he would be able to put such policies in place and that they would improve business profits. The result has been a significant rise in stock prices for companies likely to benefit from such policy changes. Some analysts have said that faster growth at a time when joblessness is already below 5 percent could cause the Fed to raise interest rates more aggressively and put the central bank in direct conflict with the president.

Fed and Treasury officials have hardly regarded Dodd-Frank as perfect.

During the presidential campaign, Trump attacked Yellen on the specious grounds that she was keeping interest rates extremely low for political reasons—that is, that she was doing it to help President Obama and Democratic candidate Hillary Clinton. That was an echo of long-running complaints by many conservatives that the low interest rate policy directed at helping restore economic growth after the financial crisis and the deepest recession since the Great Depression was going to lead to runaway inflation. Even to this day there has been no hint of that, of course.

According to the minutes of the FOMC meeting at the beginning of February, the issue of changes in fiscal policy was discussed at some length. A couple of participants, who favored raising the target for other reasons, said the possibility of a more stimulative policy should be factored in now. "However, other participants cautioned against adjusting monetary policy in anticipation of policy proposals that might not be enacted or that, if enacted, might turn out to have different consequences for economic activity and inflation than currently anticipated," the minutes said.

Earlier, at a meeting of the National Economic Club in Washington, former Fed Vice Chairman Donald Kohn, now a senior fellow at the Brookings Institution, had said much the same thing. Since no one knows what Trump may propose or what Congress might enact, and since whatever impact the policy changes might have on the economy likely would occur only gradually, the Fed should have ample time to adjust its own policies if needed, Kohn said.

When Yellen appeared before the House Financial Services Committee, she was greeted, as usual, by an opening statement from the chairman, Jeb Hensarling, a Texas Republican, complaining about "eight years of subpar growth, eight years of stagnant pay checks and eight years of unreplenished savings." Nothing personal, mind you. "Notwithstanding good intentions at the Fed and not withstanding good personnel, after eight years there is zero evidence that zero interest rates and a bloated Fed balance sheet lead to a healthy economy," said Hensarling. He and his Republican colleagues focused almost entirely on the slow pace of the recovery without ever acknowledging that the nation is close to full employment.

Trump and his advisors hadn't acknowledged that fact either when they began work on their first budget proposals. Federal budget plans typically are laid out for a ten-year period, and there are reports that Trump's will incorporate projections of U.S. economic growth accelerating modestly to around 2.5 percent for this year and next but then jumping enough to average about 3.25 percent annually over the coming decade. Unfortunately, there is no justification for that projection, which is significantly higher than the Congressional Budget Office's estimate of 1.8 percent, and the 1.6 percent to 2.2 percent range assumed by Fed officials.

The principal reason for those projections is that, with the baby boom generation rapidly retiring, the U.S. labor force is likely to expand only about half a percentage point a year. Furthermore, Trump's

House Financial Services Committee Chairman **Jeb Hensarling** *(R-TX)*

Big Fat Zero

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sweeping efforts to deport tens of thousands of undocumented immigrants and to reduce future legal immigration could make labor force growth even more anemic.

Remember, too, that with the unemployment rate as low as it is, there is little slack to be absorbed. Even an increase in the labor force participation rate, while good news, would not make a significant difference over a ten-year period.

In their blog, "Money, Banking, and Financial Markets," Stephen G. Cecchetti of Brandeis University and Kermit Schoenholtz of the Stern School of Business at New York University noted that from 1970 to 2000, U.S. growth did average 3.5 percent a year. "But critically, this was the period when the baby-boom generation was coming of age and women were joining the work force in increasing numbers. (The working-age population grew by nearly 40 percent, and the female labor force participation rate increased from 42.7 to 57.5 percent.) As result, one-half of the 3.5 percent average GDP growth over those three decades was accounted for by the change in employment," they said.

Since 2010, an even larger share of growth has come from an increase in the number of employed workers, but that has been the result mostly of people who lost their jobs in the recession finding work again.

"So, if we accept the [U.S. Labor Department's Bureau of Labor Statistics'] projection of 0.5 percent labor force growth, assume like many observers that labor resources are today close to full utilization, and extrapolate the decade-long productivity growth trend of 1.0 percent, we would end up with a ten-year growth projection of only 1.5 percent," Cecchetti and Schoenholtz said. "If you think that is too pessimistic, consider that productivity growth since 2010 has been even lower, averaging 0.7 percent per year. That is, a projection of 1.0 percent already implies a substantial pickup from recent experience."

Here is the bottom line: A 1.5 percent growth rate implies cumulative growth of 16 percent over the next decade; the apparent administration forecast of about 3.25 percent would mean that GDP in 2028 would be 38 percent above what it is today. In current dollars, that's the difference between $21.8 trillion and $26.0 trillion in total output, they estimate.

That would certainly improve the outlook for budget deficits and national debt. Unfortunately, a 3.25 percent growth assumption looks like another of the Trump Administration's "alternative" facts. Yellen and her colleagues aren't likely to use it in their longer-term policy calculations.

Meanwhile, Trump will have an opportunity to influence the Fed directly through appointments to the seven-member Fed Board. There have been two vacancies for quite some time, since the Republican-controlled Senate largely stopped the confirmation of Obama appointees no matter the job. And Fed Governor Daniel K. Tarullo, whose major role has been helping develop new risk-reducing regulations called for by the Dodd-Frank legislation, has announced his resignation as of early April.

There's no way anyone could be sure how much the value of the dollar might rise.

Under the terms of Dodd-Frank, one of the seven Board members was to be nominated by the president to be vice chairman for regulation, but no one was ever nominated to fill that position. Given Trump's focus on overhauling the legislation and reducing federal regulation generally, a nominee to fill one of the three vacancies likely would occupy that slot. How that might impact Dodd-Frank and other financial regulations is hard to predict.

When Yellen appeared before the House Financial Services Committee to present the monetary policy report, Representative Michael E. Capuano, a Massachusetts Democrat, provoked laughter when he read part of the preamble of the Dodd-Frank Act followed by part of Trump's February 3 executive order on core principles for regulating the U.S. financial system. They sounded more or less identical, and Capuano declared, "This is about motherhood, apple pie, and puppy dogs." So who could object? When he asked Yellen what she thought about the executive order, she said he had no problem with it.

Actually, Dodd-Frank and the Affordable Care Act, like many pieces of complex, major new legislation—could have been improved with some changes, supporters of both have said. But with Republicans intent on either repeal or large, fundamental changes, small fixes were almost impossible to make. Fed and Treasury officials have hardly regarded Dodd-Frank as perfect. For instance, the act set the threshold for a bank or other institution to be regarded as a systemically important financial institution—and thus subject to the stiffest rules and highest capital requirements—at $50 billion in assets. But earlier, in 2009, when large banks were first required to undergo so-called stress tests to determine if they were sound enough to stay afloat, the cutoff was $100 billion. Now even banks with between $10 billion and $50 billion must do the tests. A threshold of $100 billion might do just as well in protecting the financial system.

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Meanwhile, there is an unusual potential problem for the central bank regarding taxes. A large tax cut that might spur stronger growth than an economy already at or pretty close to full employment could readily tolerate would be one thing. An altogether different type of tax applied just to the value of imports would be another. House Speaker Paul Ryan and Representative Kevin Brady of Texas, chairman of the tax-writing House Ways and Means Committee, are pushing exactly that. The proposal seems simple but is far from it. Businesses would pay a 20 percent tax on all types of imports. Those exporting products would pay nothing. So the cost of imports paid by the importer would rise and that business could be expected to raise the price of, say clothing from Bangladesh. But advocates say, no, not necessarily, because the value of the dollar would be likely to rise, too, so the importers' cost in dollars might not rise despite the tax. So the government would get its money without inflation necessarily accelerating at all, or so the argument goes. There are two other important features of the proposal: one would end corporations' ability to deduct interest payments as a business expense, which would encourage companies to issue equity to raise funds rather than borrowing; the other would allow them to treat capital expenditures as an expense and deduct their cost immediately rather than amortizing over their useful life.

But talk about uncertainty. There's no way anyone could be sure how much the value of the dollar might rise. To the extent it went up, it would offset part of the higher cost to importers and thus would have less of an impact on U.S. inflation. However, those tax-free exports would cost foreign purchasers more in terms of their own currency, and sales of U.S. exports likely would fall unless exporters slashed their prices. Furthermore, foreign countries, businesses, and individuals have trillions of dollars' worth of outstanding dollar-denominated debts which suddenly would be much more costly to repay.

The United States benefits enormously from the fact that the dollar is the world's reserve currency. In that role, it is involved in nearly nine-tenths of the $5 trillion dollars in worldwide currency transactions each day and more than half of world trade finance. This dominant role means, among other things, that the U.S. government can borrow more cheaply than most other countries, and a deliberate move to raise the value of the dollar in this fashion could cause foreign investors to shun U.S. assets.

In short, this sort of tax reform could prove to be a major headache for the Fed as it would have to shape monetary policy to minimize the upheaval in world financial markets. Perhaps none of the problems would become acute, but the tax would pose serious risks that could be avoided with a more conventional tax reform regime. ◆