ADVISOR PERSPECTIVES

Janet Yellen: I Don't Understand Trump's Trade Policies

October 31, 2018

by Robert Huebscher

A central focus of the Trump administration has been to reduce the U.S. trade deficit and to force our trading partners – mostly China – to eliminate what he claims to be unfair trade practices. Yet former Fed Chair Janet Yellen doesn't understand what Trump is doing.

"I don't understand Trump's priorities with respect to trade," she said.

Yellen was the chair of the Fed from 2014 to 2018, overlapping both the Obama and Trump presidencies. She is now a distinguished fellow in residence at the Brookings Institution, a Washington, D.C.-based think tank.

She was a keynote speaker at the Schwab IMPACT conference on October 30 in Washington.

I'll come back to Yellen's thoughts on President Trump, but first let's review what she said about the capital markets, the economy and monetary policy.

Putting the market volatility in context

Recent market volatility is a response to a number of uncertainties, according to Yellen, including trade relations with China, which affect the global economic outlook. The market is trying to figure out where rates are heading, she said, particularly in the long term. "Movements in rates have a significant effect on stocks," Yellen said.

Even with the recent correction, the market's P/E and Shiller CAPE ratios are still "quite high by historical standards," she said.

But stocks are not patently overvalued, according to Yellen. Given that rates are still low and will normalize at a lower-than-average level, higher valuations can be justified.

If the economic expansion continues through July, she said, it will be the longest in American history. But is a recession imminent?

U.S. recessions are usually due to excesses, she said, like in housing prior to the financial crisis and in tech stocks prior to the dot-com collapse. "I am worried about the buildup in debt in the non-financial sector," she said, but there are no buildups in other parts of the economy that concern her.

Most importantly, she said there are no financial trends that "spell the end of a long expansion."

Even though unemployment is at its lowest level in 50 years, there is still a danger that the economy could overheat, according to Yellen. The Fed is trying to move to a more neutral position to avoid that overheating while maintaining growth.

She has confidence in her successor, Jerome Powell. "The Fed can slow and stabilize the economy slowly and thoughtfully," she said.

"But it could still cause a recession," Yellen said.

There has been a correction in the market but financial conditions are still accommodative. At least a couple more interest rate increases are going to be necessary to stabilize growth and employment, according to Yellen.

Prior to the crisis, the thinking was that 2% was the "normal" real interest rate, Yellen said. But as other economic trends emerged – slowing productivity rates, a high demand for safe assets and an aging population – the normal level of real rates is likely to "be low and stay low," she said. A real short-term rate of 1% is realistic, she said, with inflation at 2%.

The Fed funds rate may need to go above 3% because the economy “needs restraining,” Yellen said. She cited a number of data points that justified her forecast of higher short-term rates. When you look at the job market, there is a high ratio of job openings to unemployed people. Firms are having difficulty hiring based on survey data. Household perceptions of the job market show that people believe it is very tight and hard for firms to hire. “That should drive up wage and price inflation,” she said.

“If the labor market continues to tighten,” she said, “then inflation could pick up beyond its 2% target and force the Fed to be more restrictive.”

Why not let inflation run higher than 2%? According to Yellen, the Fed needs to be forward-looking and proactive to prevent runaway inflation. If not, she said, inflationary expectations could become a self-fulfilling prophesy and accelerate price increases. “The Fed does not want to tighten to a level that would cause a significant recession.”

“The Fed should sustain the good conditions and avoid getting too far behind the curve,” Yellen said.

Responding to President Trump

Yellen was asked a number of questions about the Fed’s relationship with President Trump.

The president has his right to express his opinions, she said, but she added that she often disagrees with him. Specifically with respect to the notion that it is unwise to continue rate increases.

“It is unwise for the president to be commenting on Fed policy,” Yellen said. Economies function better when the central bank operates independently.

Indeed, she said, the Fed has “never been political.” Its members consider and weigh a lot of opinions before decisions are made.

“What concerns me is the president undermining confidence in an institution that serves the public interest.”

Moreover, she said it would concern her if the president’s comments “continue or intensify.”

“I was always waiting for a tweet,” Yellen said when she was asked about whether she worried that the three rate hikes she undertook while Trump was in office would trigger a Twitter response.

Trump has said the Fed could go slower in its rate increases, but it is actually raising rates at half the pace that it raised them in 2004-2006, which was then considered a “measured” pace, Yellen said.

Yellen was asked if Trump is “as embarrassing and uneducated as he appears to be.” She politely responded that her personal conversations with him have been “reasonable.”

But, she said, if Trump criticizes the Fed with unrealistic economic propositions, it would undermine the Fed’s credibility.

The general outlook for 2019

Yellen offered her 2019 forecast for the economy.

Growth will be a little slower than this year, she said, predicting it will be a little above 3%. But Yellen said growth of 2% is “consistent with stable unemployment.” Growth will still be above trend, between 2.5% and 3%, she added. She said unemployment will fall further and inflation will be 2.1% to 2.2%.

According to Yellen, if the U.S. economy’s capacity to grow increases – for example from Trump’s tax cuts boosting investment spending or if the population or labor force grows – then the sustainable growth level would increase. But, she said, what’s happening with 3% growth is that unemployment is falling. “The economy can’t grow without using up the slack in the labor market,” she said.

The acceleration of economic growth in 2019 is threatened by the possibility of “overheating,” according to Yellen. Her fear is that, if GDP growth continues at its current rate, we cannot produce enough goods and services to satisfy consumer demand, and we will either have to grow more slowly or face unacceptably high inflation.

“Growth needs to slow to avoid the economy overheating,” Yellen said.

One possibility, however, is that Trump's tax cuts could increase the level of sustainable growth. Those cuts create an incentive to invest more and should raise productivity, Yellen said. Qualitatively, they have been a trigger that has spurred growth, but she said the size of the increase is debated. Most economists believe it is small – a couple off tenths of a percent of GDP growth, she said.

The effect of tariffs and the fiscal deficit

Yellen was asked how President Trump's proposed tariffs and the size of the federal debt would affect overall economic performance.

Over the next year, she said, the big impact will be what happens to consumer spending. There will be a small impact on inflation, but she is worried about the uncertainty of investment-related spending.

"Tariffs are a tax on goods and are more likely to be deflationary than inflationary," Yellen said.

The national debt is a major problem, Yellen said. We are not facing a "debt crisis," but she said that we should not think of the debt as being low. It is "scary," she said, because as the population ages, the three entitlement programs will rise from 10.5% to 15% of GDP.

"As rates rise, we are on an unsustainable debt path," Yellen said.

This is not new and reflects fewer workers per retiree and higher-than-inflation healthcare cost increases, according to Yellen.

Modest reforms of Social Security could help, she said.

"If I had a magic wand I would raise taxes and cut entitlement spending," Yellen said.

The role of the U.S. in the global economy

Yellen said that she is worried about the role of the U.S. in the global economy, specifically with respect to trade with China and the U.S. abandoning its stabilizing and constructive role on an international level.

"The rules that at least avoided protectionism have worked and restrained other countries from damaging U.S. interests," she said. Most countries were part of that world order, she said.

But, she said, we are "deep-sixing" those rules in favor of policies that she doesn't understand.

Yellen said that President Trump views trade as a zero-sum game and not a win-win situation. But it was multilateral and not protectionist policies that have been good for the U.S. and the world, according to Yellen.

Yellen said that Trump "seems to have settled things" with Mexico and Canada, and has focused on China. This has created a world of uncertainty for multinational businesses, she said, and could lead to disruption and less efficiency in corporate supply chains. "That could favor firms producing in the U.S.," she said.

She said that trade frictions with China could trigger a recession. China also has significant debt problems and its growth is slowing, but she said it won't see a hard landing. Yet, she said it is sufficiently large to have repercussions in the U.S. and globally.

Yellen was asked if China could retaliate against the U.S. by selling its large holdings of U.S. Treasury securities.

"There is a broad and deep market for Treasury securities," she said. It is not in China's interests to dump them. "It would hurt China more than it would hurt us."