What is Bill Dudley Thinking?

On August 27, 2019, Bill Dudley, former Chief Economist for Goldman Sachs and President of the Federal Reserve Bank of New York from 2009-2018, published a stunning editorial in Bloomberg (LINK). After reading the article numerous times, there are a few noteworthy observations worth discussing.

Dudley?s Myopic View

Before we dissect Bill Dudley?s opinions and try to understand his motivations, consider the article?s subtitle- ?*The central bank should refuse to play along with an economic disaster in the making.?*

There is little doubt that Trump?s hard stance on trade and the seemingly impetuous use of tariffs and harsh Twitter commentary presents new challenges for economic growth. Global trade has slowed and manufacturers are retrenching to limit their risks.

Whether the trade war is or will be an ?*economic disaster*? as Dudley says, is up for debate. What is remarkable about this comment is the lack of understanding of the economic instability prior to the trade war and how it got to that point.

As we have discussed on numerous occasions, the Fed has used excessive monetary policy over the last decade to promote economic growth. Dudley and the Fed fail to recognize that their actions have led to rampant speculation in the financial markets, encouraged significant uses of debt for nonproductive purposes, and have fueled the wealth and income divergences. More concerning, their actions have reduced the natural economic growth rate of the country for years and possibly decades to come. **Dudley and colleagues arranged the tinder for what will inevitably be an economic disaster. Trump may or may not be the spark.**

Dudley sets up his article with a leading question-?*This manufactured disaster-in-the-making presents the Federal Reserve with a dilemma: Should it mitigate the damage by providing offsetting stimulus, or refuse to play along??*

He answers, in part, by saying that, based on the Fed?s obligations and ?*conventional wisdom*?, the Fed should respond to economic weakness due to the trade war by ?*adjusting monetary policy accordingly*.? Historically, the Fed has changed policy to counter outside, non-economic factors.

Dudley, however, takes a different tack and asks if easier Fed policy would encourage ?*the President to escalate the trade war further*.? This is where the editorial gets political. He goes on to state his case for the Fed taking a hard line and not adjust monetary policy if the trade war negatively affects economic activity. Dudley believes that by doing nothing, the Fed would:

- Discourage further trade war escalation
- Reinforce the Fed?s independence
- Preserve much needed ?*ammunition*?, as there is little room to cut rates

In the next paragraph, he stresses Trump?s attacks on Chairman Powell and provides more reasoning for the Fed to leave policy alone. Dudley believes the Fed, by not adjusting monetary policy to offset the effects of the trade war in progress, would send a clear signal to the President that he bears the risks of a recession and losing an election. The Fed, thereby, would not be complicit.

Before going on, we think it?s appropriate to re-emphasize that the next recession will be amplified due to Fed actions over the last ten years. Bernanke should never have extended extraordinary measures beyond the first round of quantitative easing, and Janet Yellen had ample opportunities to raise interest rates and reduce the Fed?s balance sheet during her tenure. Trying to place all of the blame on the current President, or anyone else for that matter, may work in the media and even the populace but it does not line up with the facts.

Dudley?s Summary

Dudley concludes with a stunning and politically motivated statement- ?***There?s even an argument that the election itself falls within the Fed?s purview.*** *After all, Trump?s reelection arguably presents a threat to the U.S. and global economy, to the Fed?s independence and its ability to achieve its employment and inflation objectives. If the goal of monetary policy is to achieve the best long-term economic outcome, then Fed officials should consider how their decisions will affect the political outcome in 2020.?*

Dudley is essentially imploring Powell to base monetary policy on the coming election. If Fed independence is what Dudley cherishes, he certainly did not do the Fed any favors. This implicates elites like Dudley, one of the ?Davos Men,? who think they know better than the collective decisions of people engaged in free-market exchanges. It also makes him guilty of an effort to manipulate an election.

Summary

Here is an important question. Is this editorial solely Dudley?s thoughts, or was Jerome Powell and the Fed involved in any way? The Fed has already come out against the article, but in Washington, nothing is ever that clear cut.

If the editorial was in some way subsidized or suggested by Powell, the implications of the Fed going after the President will call into question their independence in the future. No matter how deeply improper that is, it certainly leaves open the question of whether or not people are justified in those efforts. In the same way that no Fed official should ever be viewed as complicit, no President should impose his will from the bully pulpit of the Presidency to influence monetary policy.

From an investment perspective, this is not good. The markets have benefited from a Fed that has promoted asset price inflation and sought to convince us that the economic cycle is dead. Despite sky-high valuations, investors tend to believe that these valuations are fair and that the Fed will always be there as a reliable safety net.

We do not know how this saga will end, but we do know that if confidence in the Fed is compromised, investors will likely vote with their feet.

Caroline?s Summary

We leave you with some thoughts on the subject from Caroline Baum of MarketWatch:

> *?It is hard to fathom what Dudley was thinking in advocating such an off-the-wall idea of factoring political outcomes into policy decisions. The Fed has a dual mandate from Congress to promote maximum employment and price stability. There is nothing in that mandate, or in the Federal Reserve Act, about influencing election outcomes. Nothing in there either about being part of ?the Resistance? to this president.*
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> *That would be a dangerous expansion of Federal Reserve?s operating framework.?*