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Fed headed for an unusual U-turn as Trump's trade conflicts escalate

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CHICAGO — President Trump has pummeled the Federal Reserve with insults in recent months, calling it "crazy" and blaming it for any stock market dives or ugly economic data. But now the president has thrust the fate of the economy into the hands of the organization — and the man — he has suggested he doesn't trust.

Fed Chair Jerome H. Powell and other Fed officials have signaled this week that they may have to cut interest rates in coming months to keep the economic expansion going — and counter any economic harm from Trump's escalating trade war.

Such a move would be highly unusual. It would come at a time when the economy has been growing quickly, and inflation and unemployment are low. And it could serve almost as an insurance policy on the impact of actions taken by the president, potentially facilitating his use of tariffs in unpredictable ways.

"The Fed never had to rescue the economy from past presidents' trade wars, or from policies that presidents embarked upon against the wishes of advisers," said Gary Richardson, an economics professor at the University of California at Irvine who used to be the official Fed historian.

The Fed is likely to signal its next step at its policy meeting this month, and markets are forecasting at least three interest-rate cuts by the end of the year. Powell said this week at a Fed conference in Chicago that the Fed is prepared to take "appropriate" action to keep the economy from a downturn, and stocks surged as a result.

The Fed could cut rates as soon as this month, or at policy meetings in July, September, October and December. Joseph LaVorgna, an economist at the investment bank Natixis, pointed out in a research note Thursday that "the Fed has never disappointed the markets' call for action."

Trump to Mexico: 'The tariffs go on'
President Trump renewed his tariff threat against Mexico June 6 and dismissed Republican senators who have expressed concerns about his plan. (Reuters)

The new trajectory is a sharp U-turn from where the Fed had been heading and poses risks whichever way the Fed's thinking goes.

The Fed has enormous sway over the economy through its control of a benchmark interest rate that influences virtually all lending — from mortgages to corporate loans.

As recently as late last year, the central bank was on a campaign of interest-rate increases, moves aimed at keeping the economy from overheating and inflation from getting out of bounds.

At the beginning of the year, the Fed put those interest-rate increases on pause as a result of an expected slowdown in the economy, partly from the trade conflict with China.

Further interest-rate cuts could extend an economy that this month entered its 10th year of expansion. That's important because many Americans only lately have begun to see the fruits of the hot economy in the form of healthy wage increases.

"The logic for the Fed is when you have interest rates so close to zero, you can't wait for the markets to melt down. You have to act early to prevent that," said Julia Coronado, president of MacroPolicy Perspectives and a former Fed economist.

But efforts to stimulate further growth also carry a range of potential downsides.

Interest rates, which had been near zero for years after the 2008 financial crisis, have climbed back only to about 2.5 percent. If the Fed were to begin to cut them now, it would have little room to maneuver should the economy enter a significant downturn.

The Fed made a similar cut in a healthy economy in 1995. But at that time, interest rates were 6 percent, giving the Fed plenty of room to take further action if the economy sputtered.

Questions about the Fed's direction have taken on new urgency since Trump deepened his trade war with China last month. Trump complained about the pace of progress in trade talks with Beijing and announced he would subject more Chinese goods to a 25 percent tariff and potentially bring all Chinese goods under tariff.

Then last week, Trump upped the ante by announcing he plans to put Mexico under escalating tariffs as soon as Monday for what he said were the country's failures to stem illegal migration to the United States.

Although the trade war so far hasn't had a major impact on the economy, economists say, the combination of those actions could have far more meaningful effects. And recent economic data have suggested that Trump's confrontational approach to trade is starting to have a magnified effect on the economy, especially manufacturing.

The fast-moving events have also put Powell and the central bank — which have historically prioritized independence from politics — in an uncomfortable position.

Trump nominated Powell to the top post at the Fed and he took over early last year. But the president has since lashed out repeatedly at him, going as far as to say he has some regrets about appointing him to the top central bank post and looking into whether he could fire Powell in December.

Trump has urged Powell to cut interest rates, but the central bank had pushed back, saying a strong economy with unemployment below 4 percent does not need the aid of low rates.

Now, in an unexpected turn, Trump might get his wish, in part because he is taking other actions that are slowing growth.

Tim Duy, an economics professor at the University of Oregon who runs the Fed Watch website, said the problem for the Fed might come if they do cut interest rates soon and then the trade war calms down with little impact on growth.

“They would like to be ahead of any impact, but what if it turns out to be much ado about nothing?” Duy said.

There’s widespread agreement among economists — and many GOP lawmakers — that Trump’s tariffs are effectively tax increases on American consumers and businesses. Trump argues that the tariffs are bringing China, Mexico and other nations to the bargaining table in ways that have never happened before.

If Trump goes ahead with tariffs on all Mexican imports in the coming days, the cost to a typical family of four would rise to over $1,000 a year, according to calculations by the right-leaning Tax Foundation, virtually canceling out the benefits of the 2017 tax legislation pushed by Trump and congressional Republicans.

Increasing tariffs on China or Mexico even more, as Trump has threatened to do, could result in a net tax increase for some Americans by the president, the foundation said.

Most economists outside the White House predict the economy will slow this year as the boost from the tax cuts and additional government spending begin to wear off, but the fear is that Trump’s trade approach could turn a modest slowdown into something more dramatic.

If the Fed reduces rates to counter Trump’s trade war, it might extend the current recovery, but it could trigger bubbles and would almost certainly leave the Fed with less ammunition to fight the next downturn.

“By doing whatever it takes to keep the expansion going, the Fed risks further inflating asset prices,” wrote James Dorn, vice president for monetary studies at the libertarian Cato Institute.

Dorn warns that early action from the Fed would also “further politicize monetary policy” and potentially encourage Trump to pile on more tariffs if he knows the Fed will backstop him to cancel out the worst of the economic harm.

Powell recently told CBS’s “60 Minutes” that there is “no reason” the economy cannot continue to grow for years to come. But whether he can realize that ambition is becoming increasingly hard to know.