Safeguarding Fed independence

Rate increases will squeeze US Treasury

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While, economically, the timing may be right for tightening monetary policy, the Federal Reserve should be prepared for the Trump administration to challenge its decisions. Populist rhetoric must not be allowed to lead to actions that jeopardise the Fed's independence.

The US government will bear the greatest costs of interest rate hikes. While the tightening of monetary conditions by the Federal Reserve will lead to higher borrowing costs for all, the US Treasury is the largest borrower of dollars and will feel the biggest impact. In addition to higher borrowing costs, the dollar is likely to strengthen in the light of higher US rates. This will make it more difficult for Trump to fulfil his goal of supporting US exporters who feel undermined by cheaper overseas markets.

Around 30% of the Treasury's $11.3tn in marketable debt will mature over the next year. While the Treasury has made great strides in extending the duration of its debt issuance, this still means it will need to refinance $3.4tn at an interest rate that could be twice as high. This could raise the US government's annual debt service costs by $25bn per year. That's around half the amount the administration wants to add to military spending.

There will be a still greater impact in terms of Treasury receipts since the Fed estimates its remittances to the Treasury will decline steeply from their elevated levels. In 2015, the Fed provided a dividend of more than $97bn to the Treasury. However, Fed economists have published a report that anticipates remittances dropping by more than half to $40bn over the next several years, as higher rates reduce the Fed's income.

The Fed is prepared to raise rates. Inflation measures are finally approaching its 2% target, unemployment is under 5%, and the Dow Jones Industrial Average is reaching record highs. While, economically, the timing may be right for rate increases, the Fed should be prepared for the Trump administration to challenge its decisions. The administration may go as far as suggesting that the Fed is part of a political plan to destabilise Trump's presidency. This would be a dangerous outcome for the Fed and for the global economy.

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Independence and confidence

Central bank independence is critical to ensure the stability and health of an economy. In its absence, political leaders from Germany to Zimbabwe have been known to abuse monetary authorities' power to increase the money supply. This can provide temporary stimulus to an economy, but inflicts long-term damage. The difficulty is the Fed's dual mandate – stabilising prices and maximising employment – may put it in an intractable position.

The Fed can justify increases in interest rates as pursuing price stability. However, tightening policy can be scrutinised against its second mandate of maximising employment. If the economy slows later this year or over the course of the next four years, one can imagine Trump using the Fed's rate tightening as a scapegoat to rationalise lacklustre growth.

Complaining about rate increases is acceptable, but the issue becomes grave if the Fed's independence is compromised. During the presidential election, the Fed was criticised by both sides of the political spectrum. Trump stated numerous times that he felt Fed Chair Janet Yellen sided with Barack Obama and the Democrats with the direction of Fed policy.

Populist rhetoric must not be allowed to lead to actions that could jeopardise the Fed's independence. Recent US leaders have, for the most part, been supportive of the Fed. Before selecting Ben Bernanke as Fed chair, George W Bush said, 'It's this independence of the Fed that gives people not only here in America, but the world, confidence.' We must hope that Trump is guided by the same spirit of responsibility. ■

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