

*Chairman Kevin Warsh should pursue a slate of reforms to rebuild market confidence.*

## Trump is Right: The Fed's Economic Models Punish Growth

By David Malpass

As President Trump heads to France for the Group of Seven meeting, the U.S. economy is riding an incredible wave of innovation and investment that will propel growth for decades. The Federal Reserve, meanwhile, is debating reforms that would help sustain the expansion as the Fed's new chairman, Kevin Warsh, faces an uphill battle with the rate-setting Federal Open Market Committee. Fortunately, Mr. Warsh is getting help from the decline in oil prices and Mr. Trump's clear pro-growth, supply-side message.

The Fed needs to be reformed. It hasn't been achieving price stability. It has lost hundreds of billions of dollars after growing in the wake of the 2008 financial crisis. Its ample-reserves policy crowds out small businesses and market innovation. Its purchases of government bonds feed inequality.

The most pressing issue concerns the Fed's obsolete economic models, which punish growth. When the economy or jobs grow fast, the Fed's Keynesian models prescribe rate increases. These models are built on the view that growth causes inflation and the Fed should enforce a low speed limit. Note

The Fed's inflation targeting sends wrong signals. Inflation is subject to distortion from fluctuations such as the current oil price shock and China's dumping in the 2000s, which kept U.S. inflation artificially low, contributing to the 2008 financial crisis. The inflation model looks backward, misjudges regulatory burdens, undervalues energy production and ignores changes in the value of the dollar. It can't keep pace with our fastchanging digital economy.

The Fed's output-gap model calculates a low growth-rate potential. The central bank's Phillips curve model looks for a balance between inflation and unemployment, as if too much job growth causes inflation. A Fed paper in April argued that near-zero job growth should be expected due to weak demographics and low immigration.

These models don't take adequate account of the dynamism of the economy and the improved incentives to work. Employment data reported on June 5 showed 172,000 new jobs in May, far exceeding forecasters' expectations. Investors reacted by assuming higher interest rates, because in the Fed's models, fast job growth is a red flag that wages will increase, and wage gains are interpreted as inflationary.

In his contentious "Meet the Press" interview on June 7, Mr. Trump challenged the Fed's limit-to-growth thinking head-on, saying: "Growth is the greatest thing you can have, and growth does not cause inflation. . . . We had great job numbers. . . . We're building more factories. We have more money coming into our country right now from other countries and people than ever before. . . . I don't want to just kill it with high interest rates."

The president was making a clear supply-side argument. Faster growth allows more output and attracts investment, reducing inflation. The administration should also endorse long-term stability for the dollar, which would make investments in the dollar more attractive and push down bond yields.

The president has railed against the higher yields on Treasury bonds (4.5%) than on weaker bonds such as France's (3.7%), Germany's

(3%) and China's (1.75% in yuan). That differential would narrow substantially if investors knew the administration wanted the dollar to hold its value long-term as a foundation for price stability and dollar-based stablecoins.

President Ronald Reagan's economic boom showed that fast growth can bring lower inflation and interest rate cuts. Through tax cuts and energy deregulation, confidence soared, drawing buyers to the dollar and dollar debt, and helping

interest and mortgage rates fall sharply. Reagan achieved years of 4% real growth and eight quarters above 6%. The growth windfall funded greater investment and production, solving the inflation problem that plagued the 1970s.

A similar boom is possible now if the Fed can implement major reforms. Current models can be improved on the margin, but they are way too grounded in demand management. They need to be replaced with economic models that welcome strong investment, innovation and job growth and recognize dollar stability as a prerequisite for price stability.

Markets expect high interest rates to extend well into 2027. Falling oil prices argue against rate increases now, but several members of the 19-member FOMC—seven governors and 12 presidents of regional Fed banks—have been leaning toward hikes, making reforms urgent.

The Fed should shrink its balance sheet to allow private-sector liquidity markets to rebuild, reduce staff and buildings, include the dollar in its inflation models, disentangle the Fed from fiscal policy, extract itself from the climate regulatory morass, and allow regulatory innovations in banking and liquidity markets. Such reforms would rebuild market confidence in the dollar and dollar debt, opening new avenues for faster growth and lower interest rates.

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