This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit https://www.djreprints.com.

https://www.wsj.com/articles/trump-the-fed-and-interest-rates-11561760850

OPINION | THE WEEKEND INTERVIEW

Trump, the Fed, and Interest Rates

Judy Shelton, a leading candidate for the central bank's board, offers philosophical support for the president's impulses on monetary policy.

By Tunku Varadarajan

June 28, 2019 6:27 pm ET

Washington

These are dizzy days for monetary economists. Mario Draghi, president of the European Central Bank, gave notice in a June 18 policy speech that his beleaguered shop could cut interest rates even further than it has already if Europe's economy continues to deteriorate.

The euro fell almost instantly against the U.S. dollar, causing President Trump to tweet that the "stimulus remarks" of Mr. Draghi were "very unfair to the United States." In an earlier tweet, Mr. Trump had suggested that Mr. Draghi's words amounted to currency manipulation, adding that the Europeans "have been getting away with this for years, along with China and others."

Watching this turbulent dance is Judy Shelton, a 63-year-old monetary economist Mr. Trump is considering to fill one of the two vacant seats on the Federal Reserve Board. Ms. Shelton, a lifelong advocate of "sound money," doesn't cut Mr. Draghi any slack.

"For too long," she says, "we've given central-bank officials a pass when they hint at 'additional stimulus' to make their own economies more competitive—without acknowledging the impact of differential interest-rate policies on exchange rates."

Even nuanced statements of the sort Mr. Draghi made—words that hint at the future direction of monetary policy—can lead to significant shifts in foreign-exchange markets, Ms. Shelton says. "When countries engage in competitive devaluation of their currencies to gain an export advantage over their trade partners, it's not competing. It's cheating."

Ms. Shelton, a frequent contributor to these pages, is U.S. executive director of the European

Bank for Reconstruction and Development, an institution set up in London in 1991 to help the countries of the former Soviet bloc make the transition to capitalist democracy. Mr. Trump appointed her to that job after she served as his campaign's senior adviser on international economics. So it is as fair to say the president's views on the subject of "unfair" exchange rates track Ms. Shelton's as it is to observe that her views echo his.

ILLUSTRATION: TERRY SHOFFNER

Currency manipulation has "been unaddressed for too long," Ms. Shelton says in a conversation at the Trump International Hotel, where she has taken a suite on a visit from London. "It's changing the terms of trade," she adds indignantly. Reaching back to the 1980s—when Japan, not China, was America's economic bugbear—Ms. Shelton remembers auto workers telling her that "we can compete against the best in the world, but we can't compete against the central bank of Japan."

Ms. Shelton is most preoccupied with "the influence of stable money on the efficiency of free-market capitalism." She insists that "stable money is the only proper foundation for capitalism. When you start to use money as a tool of government, for regulating the economy, then that's at the expense of what money is meant to be—which is a reliable measure of dependable stored value."

Sound money works "the same way for everyone" rather than "channel benefits to one sector of the economy at the expense of another." Whom does she have in mind? "Money should not reward wealthy investors, who can borrow vast sums on margin, at the expense of ordinary savers who earn next to nothing on their bank accounts. Monetary favoritism is demoralizing." The goal of monetary policy is "to have dependable money both domestically and internationally. Not a weak dollar, not a strong dollar—a trustworthy dollar."

In short, "the value of money should not be an economic variable itself, subject to the discretionary and varying judgments of a small committee of people trying to decide what should be the appropriate interest rate when they meet eight times a year." She means the Federal Open Market Committee, whose fourth meeting of 2019 took place this month. It's a piquant remark, given that Ms. Shelton will be a member of the committee if she's appointed to

the Federal Reserve Board. And she makes no effort to conceal her view that the Fed "has gotten way too dominant," is "way too big an influence in people's economic calculations, and has far too strong an effect on financial markets."

Should the Fed reduce interest rates? "The answer is yes," she says—again, matching Mr. Trump's preference. "When you have an economy primed to grow because of reduced taxes, less regulation, dynamic energy and trade reforms, you want to ensure maximum access to capital. Today we are seeing impressive gains in productivity, which more than justify the meaningful wage gains we are likewise seeing—a testimonial to the pro-growth agenda. The Fed's practice of paying banks to keep money parked at the Fed in deposit accounts instead of going into the economy is unhealthy and distorting; the rate should come down quickly as the practice is phased out."

Ms. Shelton first made a name for herself in 1989, when she was a fellow at Stanford's Hoover Institution. Early that year she published a prescient book, "The Coming Soviet Crash: Gorbachev's Desperate Pursuit of Credit in Western Financial Markets," which argued that the Communist regime in Moscow could not survive if misguided Western leaders stopped propping it up. She says the lesson of the Soviet experience—that "free markets deliver better economic outcomes than central planning"—applies to monetary policy: Why "permit the most important price for channeling financial resources to their most productive use—i.e., the cost of capital—to be determined by a government agency?" She calls this "an anomaly to free-market capitalism, the world's most successful economic experiment in individual liberty."

That sounds a bit like a political slogan, and journalists reflexively describe Ms. Shelton as a "conservative economist." But she's as comfortable in the policy weeds as she is taking ideologically clamorous positions. "The more compelling question for Fed officials," she says, "is to decide how expediently they can move to eliminate the damaging impact of their crisis-born mechanism for setting interest rates." The Fed "needs to wean itself off its practice of paying commercial banks interest on excess reserves"—currently 2.35%. "Our nation's central bank should not be coercing private-sector banks to maintain sterile depository accounts at Federal Reserve district banks rather than make loans to small and medium-sized businesses—to the entrepreneurs who create jobs."

If Ms. Shelton doesn't end up at the Fed, it won't be because she disagrees with the president on policy. She speaks glowingly of the "pro-growth economic agenda that has been launched under the Trump administration" and argues that key policies—"reducing the regulatory burden, cutting taxes and fighting for genuine trade reform"—need to be "sustained and further empowered through substantive international monetary reform."

Here's what that means for trade policy: "Other nations indulge in currency warfare through unfair trade practices disguised as 'discretionary monetary policy' to undercut the price of rivals in the global marketplace." Mr. Trump "is taking the moral high ground by insisting that countries seeking to gain a trade advantage through monetary sleight of hand should be called out." It is not protectionist, she says, to demand "a level monetary playing field as the only proper foundation for genuine free trade."

How do you integrate domestic and international monetary policy to level the playing field for free trade? She says the process "might be started by having the Treasury engage in a limited issuance of a new type of security linked to gold, something akin to TIPS bonds"—Treasury Inflation-Protected Securities—"which compensate holders for unanticipated inflation."

Ms. Shelton, long an advocate of the gold standard, sees a way to resurrect that doughty metal in pursuit of this level playing field. "Gold is universally recognized as a monetary surrogate," she says, "and could serve as a useful benchmark or international reference point" for exchange-rate movements. "We are recognizing that currency manipulation is a serious problem," she says. "When nations gain a price advantage over competitors by devaluing their currencies, it undermines free trade and justifies tariffs. One way to address this unfair trade practice could be through gold-convertible bonds issued by governments that provide compensation to the injured party."

So if China's currency depreciated against the dollar, "the gold reference point would determine the extent to which China's exports gained a price advantage." The holder of gold-linked bonds issued by China would have the option to be paid in gold instead of depreciated yuan.

Given her strong views on economic policy, it comes as no surprise that Ms. Shelton is often in a minority when the board votes at the European Bank of Reconstruction and Development, although the U.S. is its biggest shareholder. She describes the bank as having "an identity crisis, somewhere in between the Gates Foundation and a Wall Street hedge fund." The EBRD is "unique," she says—"the only multilateral development bank that was founded with a political mandate." Its purpose was to educate the leaders of former Soviet republics and satellites for political and economic freedom.

"They knew nothing about democracy," Ms. Shelton says. "Nothing about market economics. And so the West thought, 'How do we help these countries transition from authoritarian central planning to democratic free markets?' " The EBRD opened its doors 18 months after the Berlin Wall fell, and eight months before the Soviet Union dissolved.

The biggest irony—"though a gratifying one," Ms. Shelton says—is that Russia, the EBRD's biggest client from the start, has been cut off from new financing since it annexed the Ukrainian region of Crimea in 2014. "It was a very difficult decision," she says. "Russia was the primary customer. The bank was set up mostly to help Russia." She adds that Russia still has "an activist director . . . who never stops trying to get back on the train."

She describes the EBRD as "like a mini-United Nations—tilting at China one day, trying to carefully stage-manage EU-versus-non-EU interests the next, all while disbursing billions in new loans every two weeks." The bank has strayed far from its founding principles, she adds. While it continues to make equity investments in private-sector projects, it has lost sight of "its original mandate of moving countries towards democracy and market economies." Instead, the bank has chosen to focus more on "other values, such as 'inclusiveness' and 'green,' which they regard as evidence of political 'transition.' That's fine, that's important, but I would have liked to see it define its work more in terms of free people, free enterprise, free markets."

The problem is that the focus on environmentalism appears to come at the expense of political freedom. "You might," Ms. Shelton says, "give finance for wind farms in a country with an autocratic leader. But it would be considered to be of 'transition impact' because it satisfied the green goal."

Ms. Shelton finds that the EBRD is "too willing to work with governments such as Belarus, where you have Alexander Lukashenko, who's been in power since 1994." Mr. Lukashenko is not "someone who is looking for free, competitive elections. So I'm thinking, 'What are you doing? Why are you encouraging people to invest in projects that are owned by the government of Belarus?'"

The EBRD likes countries to be "resilient," Ms. Shelton says, mentioning another shiny new value that has eroded the bank's original raison d'être. "I understand that. Resilience is great. But our work now has less to do with displacing dictators than going green. I don't see democracy mentioned so much now."

Mr. Varadarajan is executive editor at Stanford University's Hoover Institution.

Copyright © 2019 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit https://www.djreprints.com.