EconoFact Chats: The Risks of Politicizing the Federal Reserve
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I'm Michael Klein, executive editor of EconoFact, a non-partisan web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
It's typically not a good sign when the Federal Reserve is the subject of a lot of news stories, for much the same reason it's not great when the Center for Disease Control is in the news. It could be that there's a lot of coverage because bad things are happening, like, for the CDC, a pandemic or, for the Fed, inflation, or a recession. Alternatively, it could also be because these agencies are getting attacked by politicians. The Fed has been in the news lately because of attacks from the President who has called the Fed Chairman Jerome Powell, among other things, "either corrupt or stupid," and said "that jerk will be gone soon." Many attribute these, and other, remarks to Trump's frustration that the Fed has not lowered interest rates to the level he would want. Most recently, the Department of Justice has started a criminal investigation against Powell related to his congressional testimony about the renovation of the Fed's headquarters. This was seen by many as a bridge too far, and pushback has come from all the former Chairs of the Federal Reserve, members of Congress, people in the financial community, and monetary authorities abroad, all of whom are concerned about the independence of the central bank. Why is this independence important, what are the possible implications of limiting the Fed's independence? And is there historical precedent for these attacks? To answer these, and other, questions about the Federal Reserve I'm very pleased to welcome to the podcast Professor Kenneth Kuttner of Williams College. Ken is widely recognized as an expert on monetary policy. Along with his academic career, he served as Assistant Vice President in the Research Departments of the Federal Reserve Bank of New York, and the Federal Reserve Bank of Chicago. I'm also proud of the fact that he has published a number of impactful memos on monetary policy for EconoFact. Ken, welcome to EconoFact Chats.

Kenneth Kuttner
Thanks, Michael.

Michael Klein
I'll start by posing a question that I also ask my students in my macroeconomics class. We know that there are three branches of government in the United States – executive, legislative, and judicial. Which branch is the Fed part of?

Kenneth Kuttner
Well, that's a trick question, Michael. It's none of the above, of course.

Michael Klein
Yep, you're right. It's a trick question. And in my class, people often are stymied by it. So why is the Fed not part of the executive, judicial, nor legislative branches of the government, Ken?

Kenneth Kuttner
Well, it's funny. It's a very unique institution. You could call it an independent agency in the sense that it's a creation of the government, but technically it's not part of the government, unlike nominally independent government agencies like the SEC or the FTC. Moreover, while the Board of Governors, including the chair, are presidential appointees, as they are for other agencies, the 12 Reserve Bank governors are not. They are appointed by the banks' boards of directors, not the President.

Michael Klein
So this unique status is one source of the Federal Reserve's independence. Why is it important that the Fed, or any other central bank, is able to stand apart from the political process?

Kenneth Kuttner
Well, very simply, as we're seeing now, because the near-term personal and political interests of the President, and Congress for that matter, may not align with the public interest as embodied and expressed in the Fed's statutory objectives of price stability and maximum employment. Presidents understandably typically like to juice the economy to gain political advantage, even if it means sacrificing price stability down the road, and we've seen this happen before. Lyndon Baines Johnson – LBJ – reportedly put the screws on William McChesney Martin. Nixon's attempts to pressure Burns are well known, and we learned about them from the White House tapes.

Michael Klein
So what happens if central banks are subject to political pressure?

Kenneth Kuttner
Well, loose monetary policy may be able to artificially boost the economy for a while, but that tends to eventually lead to higher inflation. Not to overdramatize. We're not talking about Zimbabwe- or Venezuela-level hyperinflation, which is more from central banks printing money to cover budget deficits. It may be more of a Turkey scenario, for example, with inflation not getting wildly out of control, but consistently overshooting the target.

Michael Klein
Although the President has spoken about [how] lower interest rates would make it easier to finance the government's very large debt, right?

Kenneth Kuttner
That's true. That is something that is tantamount to printing money, so another way in which the President's incentives might not line up with the Federal Reserve's.

Michael Klein
How is the Fed set up to resist these pressures, other than its separation from the Executive and Legislative branches?

Kenneth Kuttner
Well, one way in which that happens is that governors serve staggered 14-year terms. The chair is appointed or reappointed in the year following the President's inauguration for a four-year term. And as mentioned previously, the 12 Reserve Bank presidents are not presidential appointments. And critically, Fed officials can only be dismissed for cause, meaning misconduct or [in]ability to perform the duties of the office. That principle looks like it's being put to the test in the foreseeable future, but fortunately the Supreme Court has hinted in its other decisions that the principle still holds in the case of the Fed.

Michael Klein
There was that other Supreme Court decision about executive branch agencies, and they seem to carve out the Fed from other agencies. They said the Fed had sort of a unique standing, which you've alluded to already.

Kenneth Kuttner
Yes, that's right. Exactly how that's going to play out ultimately in the decision remains to be seen, but the Supreme Court does appear to have tipped its hand on that matter.

Michael Klein
Well, we're recording this on January 16, and it remains to be seen what the Supreme Court actually does decide. The Chair of the Fed does not make monetary policy decisions on his or her own — these decisions are made every six weeks by the Federal Reserve's Open Market Committee. Can you describe the makeup of this committee, and the role that it plays?

Kenneth Kuttner
Sure. Well, like everything Fed, it's a little complicated. 7 of the 12 members of the Federal Open Market Committee, or FOMC for short, are the governors, the presidential appointees. The other five are the Reserve Bank presidents, who serve on a rotating basis. And one should not

overlook the important role of the professionals on the Fed staff – the economists and analysts who perform the analysis and typically frame the policy decisions underlying the vote at the FOMC. The FOMC members take the work by the professional staff very seriously, and to some extent that disciplines, and serves as ballast for the decision-making process.

Michael Klein
To what extent do the members of the Board of Governors provide a counterweight to the desires of the Fed chair? That's become a really important issue now, as Trump is poised to select a new chair of the Fed.

Kenneth Kuttner
Well, that's an interesting question, Michael. Obviously, if you're just looking at the number of voting members, twelve, no single member of the Board of Governors, or president of the Reserve Banks…can easily be outvoted by the others if they get too far out of line. But it's hard to answer definitively, because if you read the historical transcripts from the FOMC meetings, you'll really be hard-pressed to find heated disagreements or drastic differences of opinions in the past, between the chair or other members, or between members of the FOMC. In the past, committee members have typically been open-minded, receptive to the views of their colleagues, and a real effort is made to reach consensus. Typically you don't see very many dissents, and when they do occur, the dissents have generally been based on good-faith differences in assessments of economic conditions, or the risks the economy faces. But that may change if the FOMC becomes more politicized, and decisions are made less on economic conditions and more on the basis of presidential priorities.

Michael Klein
Do you think that's already changing a bit with Stephen Miran on the Federal Reserve Board of Governors? Although he has only taken a leave of absence from his role in the White House, and he voted a dissent on the latest FOMC decision. He wanted to lower interest rates by more than the FOMC did.

Kenneth Kuttner
I think the short answer would have to be yes. And actually that's a good point you bring up. Another way in which the Fed has traditionally been independent from the executive branch is that the executive branch has not appointed members of the administration, like the Treasury Secretary, or its own people to the Federal Reserve Board. That's more of a tradition than a part of the Federal Reserve charter, but it's a tradition that's obviously been broken in this case.

Michael Klein
Well, people talk about guardrails in the United States, which are not black-letter law, but things that have been honored. And I guess this is yet another guardrail that has been breached.

Kenneth Kuttner
That's exactly right. This is another example of something that has been true by tradition or true by general agreement, but now we're seeing that go by the wayside.

Michael Klein
What evidence is there that central banks that are not insulated from the political process deliver worse economic outcomes? Is it only instances like Zimbabwe or Venezuela, or even Turkey? Or more generally, in less extreme cases, is this also true?

Kenneth Kuttner
Yes, for the reasons mentioned earlier, political pressures typically [push] for more expansionary policy, and hence higher inflation. There has been a lot of research in academia and elsewhere showing that central banks that are more independent and less subject to political pressure do in fact tend to have lower inflation rates, all else equal.

Michael Klein
And in fact, there's a famous paper which shows that while they have lower inflation rates, central banks that are more independent don't come up with higher rates of unemployment, right?

Kenneth Kuttner
That's right, and that's for the simple reason that the trade-off between output and inflation is temporary. In the near term, you can achieve higher employment by expansionary monetary policy that also increases inflation, but eventually the economy will return to an equilibrium that is independent of monetary policy – the so-called principle of monetary neutrality. So more stimulative policy may have some short-run benefits, but nothing in terms of output or employment in the long-run.

Michael Klein
So for those of you who have taken macroeconomics, this is the difference between the short-run Phillips curve and long-run monetary neutrality that Ken referred to. And if you remember that…

Kenneth Kuttner
The long-run vertical Phillips curve.

Michael Klein
Yeah. So if you remember that, kudos to you. And you should write back to your old macroeconomics teacher and thank him or her for the insights that you still retain. So Ken, as I

mentioned, you've contributed quite a few memos to EconoFact, which we really appreciate. And your most recent one includes original research you conducted to look more closely at central bank independence, and how that independence depends not just on regulations, but more broadly on the rule of law and institutional integrity in the economy. Can you describe why you undertook this research and what you found?

Kenneth Kuttner
Well, not surprisingly, I was motivated to do this research by the current situation in this country. The situation we find ourselves in now is a reminder that even central banks that look independent on paper, that is we like to say, on a de jure basis, are not necessarily going to be immune to political pressure. And so, what we're seeing now is described by that situation, where there's been no change in the central bank charter, no change in the Federal Reserve Act…we're seeing pressure being put on it in spite of [inaudible] legal basis. So I hypothesized that in a weak institutional environment, characterized by governmental dysfunction and distrust, even notionally independent central banks could be susceptible to political pressure and hence experience higher inflation. And indeed, I went and collected data on inflation rates, institutional quality, and central bank independence that other people have put together, and found that institutional quality is generally just as important, if not more so, than de jure…that is to say on-paper independence – in terms of delivering good policy outcomes and low inflation.

Michael Klein
I was really taken with that memo. I thought you did a great job with it. In terms of weak institutional environment, I guess one could think about a situation where there are supposed to be checks and balances, but they're not in fact operating. That would be an example of a weak institutional environment, wouldn't it?

Kenneth Kuttner
That's correct. One dimension of a weak institutional environment, rule of law, general perceptions of high government functioning, things like that…there are a number of different dimensions of that, and obviously, in this context, rule of law is one of the most salient ones.

Michael Klein
You mentioned before the way in which President Nixon leaned on Arthur Burns to stimulate the economy in advance of the 1972 election. How did Nixon's actions compare to what President Trump has done, not only regarding Chair Powell, but also with respect to board member Lisa Cook, and putting Stephen Miran on the board, who as I mentioned, retained his White House role?

Kenneth Kuttner
There really is no comparison, Michael. At least not in this country. The pressure on Nixon occurred behind closed doors, and we wouldn't have known about it at all had it not been for the tapes. Now of course the pressure is all over social media, and in the headlines, day in and day out…which as you said at the outset, it's never a good thing when the central bank is in the news too much. Nixon never threatened criminal prosecution on Burns. The only parallels I can think of are in places like Turkey and Argentina, where central bank governors were fired over policy disagreements, but using flimsy misconduct charges as pretexts.

Michael Klein
What are the likely effects of this, in the short run, and over the longer horizon?

Kenneth Kuttner
Well, bondholders don't like inflation and they will demand higher yields to compensate for an increase in expected inflation. So if the attacks on Powell led to a sudden increase in inflation expectations, we would see that show up as a spike in bond yields. Now there have been a few jitters in the bond market, but no panic so far, which is surprising me a little bit, but it's perhaps a sign that investors think the Fed will be able to withstand the pressure, at least for now. But since price-setting decisions today depend on what people think inflation is going to be down the road – a topic of one of my other EconoFact memos by the way – the Fed's credibility plays a key role in keeping prices stable. Continued attacks on the Fed will likely erode that credibility, making it that much harder to bring inflation back down to the 2 percent target, and keep it there.

Michael Klein
You've written so many memos for us Ken. I want to refer to another one now, about the importance of the 10-year treasury rate. And I guess it's ironic that Trump's pressure on the Fed to lower rates could actually, as you're alluding to, raise rates because of higher expected inflation, so people will demand higher interest rates to insulate them from the effects of higher inflation. So this could be a lose-lose strategy for the President, right?

Kenneth Kuttner
That's correct Michael. The hope is that bringing down short-term rates will also bring down long-term rates, and that would decrease the cost of financing houses for example. But the effect going the other direction, that's only going to work so far as inflation expectations remain anchored, and if the cut in interest rates is a signal that inflation will be allowed to get out of control, or at least edge up from the target, that's going to increase those long-term rates [inaudible] in the sense it's going to increase the cost of buying houses, and financing business investment.

Michael Klein
So do you think the possibility of these adverse outcomes are why people from Janet Yellen to Jamie Dimon and, maybe even Scott Bessent according to some news reports, are saying that these attacks on the Fed are ill-advised?

Kenneth Kuttner
Absolutely. These are all people…Janet Yellen, Ben Bernanke, Alan Greenspan, Jamie Dimon, and as you mentioned at the outset, more than a dozen heads of central banks from around the world, these are all people who understand the economic and financial benefits of central bank independence, and the stability and credibility that fosters, and the potential damage that can be done if that stability and credibility are undermined.

Michael Klein
The President has recently discussed affordability. And it seems like he sees this as a vulnerability, even when he says it's just a 'democratic hoax.' But his attacks on the Fed are likely to worsen affordability, rather than make things better, right?

Kenneth Kuttner
Yes. Brow-beating the Fed into cutting rates may give employment and wages a short-term boost, and obviously, we would like that, but rising prices would likely erase those gains at some point, probably within a time span of maybe as short as a year. Higher inflation would raise mortgage rates as I mentioned, and actually make housing less affordable. And it's not hard to think of more direct ways to improve affordability frankly…reducing tariffs perhaps being the most obvious.

Michael Klein
So, there have been complaints from the President, and people in his administration about the Fed's policies over the past 5 or 6 years. To what extent do you think the Fed got things right, and to what extent did they not make the right decisions?

Kenneth Kuttner
Well it's always fun to play Monday morning quarterback, especially when it comes to monetary policy. Ex-post, sitting here, with a 5 years perspective, down the road after COVID, it looks to me like the extended period of super expansionary policy coming out of COVID – low rates combined with very aggressive quantitative easing – may not have been advisable. Estimates of the magnitude of the effect on inflation vary, but expansionary policy probably accounted to some extent of that 2021-22 surge in inflation. And in any case, the expansionary policy did very little to address the underlying causes of the downturn in activity. 5 years later, it's easy to forget the extreme uncertainty policy makers were operating under at the time. And in that environment, it's hard to blame them for erring on the side of excessive stimulus.

Michael Klein
Also, there's research, for example by Ben Bernanke and Olivier Blanchard, that the fiscal stimulus also contributed importantly to inflation…not just the monetary stimulus, right?

Kenneth Kuttner
Absolutely. It was really a combination of factors. The fiscal stimulus and then on the, what economists like to call the supply-side, the cost of so many goods spiked because of the famous supply chain disruptions, and just the lack of availability of many of the basics, and consumer durables. Supply became so constrained that the price of all those goods was driven up.

Michael Klein
So Ken, sometimes the argument is made that in a democracy, institutions like the Fed should not be insulated from the public. Given this, do you think that the Fed's past policy decisions merit greater oversight from the executive or legislative branches?

Kenneth Kuttner
Well central banks do need to be accountable. I think it would be a mistake, and counterproductive in the long run, for central bank independence, for central banks to appear to be too independent and unresponsive to the preferences of the population. And if central banks fail to achieve their objectives – in this case, stable prices, low inflation, and maximum employment – they have an obligation to explain to the public, and to elected officials, why they missed the targets. And if it was the result of bad policy, and not just bad luck…and how the mistake could be avoided in the future. The Fed already does this to some extent in the chair's semi-annual testimony to Congress. But a more structured procedure, like what we typically see among central banks with full blown inflation targeting policy frameworks, I think might not be a bad idea.

Michael Klein
Well Ken, I've alluded to a number of the memos that you've contributed to EconoFact. And I would suggest to anybody listening to this who wants more information to go to our site, and they can search by your name and find all the really good work that you've done for us. So I want to thank you for taking the time to talk with me today, and also thank you for all the great contributions you've made to EconoFact.

Kenneth Kuttner
You're welcome, Michael. It's been a pleasure.

Michael Klein
This has been EconoFact Chats. To learn more about EconoFact, visit www.econofact.org. EconoFact is a publication of The Fletcher School at Tufts University. Thanks for listening.