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# Politics, Independence, and Long-term Low Interest Rates at the Federal Reserve

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A narrative of central bank independence took root in the mid-20th century and flourished from the 1980s until the global financial crisis. In that narrative, a central bank is designed to protect the people from their own worst instincts. The populace will demand easy money and low interest rates, and a politically sensitive representative class will give it to them. Central banks are given political independence, such as it is, to resolve this time consistency problem by protecting the long-term value of the currency even against the short term demands of politics. As with so much else, two of the defining events of the 21st century—the global financial crisis of 2008 and the 2016 election—have changed this standard narrative. Today, the U.S. Federal Reserve and other central banks are more likely to face political pressures to raise interest rates rather than lower them. This chapter explores how this new political economy of central banking, in the face of long-term low interest rates, changes the posture of central banks against the rest of the polity. It discusses some history of political pressures against central banks in other climates and makes predictions about how the “new normal” of lower interest rates will challenge the Fed’s ability to stay above the political fray, despite its best intentions.

## **Disciplines**

Economics

## **Comments**

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Peter Conti-Brown

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# Politics, Independence, and Long-term Low Interest Rates at the Federal Reserve

Peter Conti-Brown

## Abstract

A narrative of central bank independence took root in the mid-20<sup>th</sup> century and flourished from the 1980s until the global financial crisis. In that narrative, a central bank is designed to protect the people from their own worst instincts. The populace will demand easy money and low interest rates, and a politically sensitive representative class will give it to them. Central banks are given political independence, such as it is, to resolve this time consistency problem by protecting the long-term value of the currency even against the short term demands of politics. As with so much else, two of the defining events of the 21<sup>st</sup> century—the global financial crisis of 2008 and the 2016 election—have changed this standard narrative. Today, the U.S. Federal Reserve and other central banks are more likely to face political pressures to *raise* interest rates rather than lower them. This chapter explores how this new political economy of central banking, in the face of long-term low interest rates, changes the posture of central banks against the rest of the polity. It discusses some history of political pressures against central banks in other climates and makes predictions about how the “new normal” of lower interest rates will challenge the Fed’s ability to stay above the political fray, despite its best intentions.

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President Donald Trump enjoys comparing himself to one of his most important predecessors, Andrew Jackson, including by hanging Jackson's portrait in the Oval Office. While he has not elaborated on the comparison, but it is not difficult to draw the parallels. Old Hickory is perceived to be the father of populism, an irascible opponent to much of the prevailing political order of his day. Donald Trump sees himself the same way: an outsider who challenged the existing hierarchy, and won.<sup>1</sup>

There is an important extra dimension to the comparison, though, that points to a future for the President, not the past. Jackson was also the sworn enemy of the Second Bank of the United States, a quasi-private institution that functioned as the nation's central bank (as that term was understood at the time). And while Mr. Trump's posture toward the Federal Reserve System (Fed) has varied, for reasons described below, there is a coming confrontation with the Fed that will tell us much about its future.<sup>2</sup>

That the Fed is now occupying a front-and-center role in the political arena is not a comfortable place for the central bankers who run it. Yet it is not new. Since the global financial crisis of 2008, the Fed has rarely receded from the political maelstrom, for better and worse.

This chapter charts this political terrain, focused on a question that is, I argue, as much economic as it is political: why are interest rates so low, and what does the Fed have to do with it? Whether the Fed dictates the national (and international) interest rate climate, or is merely a victim to secular economic trends in productivity is an ongoing debate, one I will summarize but not fully engage. Of more pressing interest is how the Fed is perceived politically, as combatant in that process. Low interest rates represent a profound political problem for the Fed. Not only do they violate the Fed's often forgotten third mandate to maintain 'moderate long-term interest rates;' they also scramble the political constituencies that have normally defended the central bank against

attempts at political interference. As a result, when political push comes to existential shove, the Fed's monetary policy actions since 2008 risk alienating another important group: pensioners and other retirees who count on a higher interest rates for their economic security and who have historically been staunch defenders of an independent central bank.

The members of the Federal Reserve System are some of the best political infighters in Washington. They have survived extraordinary assaults on its independence and structure throughout the last century. Time and time again, the Fed has not only survived, but thrived.<sup>3</sup> But the challenges ahead will be different, and they will require something more than the Fed has done before.

This chapter proceeds in three sections. In Section 1, I discuss the nature of equilibrium interest rates and the Fed's (in)ability to influence them. I also discuss why the perception that the Fed can control real interest rates is not simply just public misinformation; it is also written into law. In Section 2, I trace the history of the Federal Reserve's own self-description as an independent central bank designed precisely for the purpose of dictating higher interest rates than politicians would prefer. Long-term efforts to push this narrative have now come back to haunt the Fed as it continues to maintain independence while pursuing the central goal of keeping nominal interest rates at historic lows. In Section 3, I discuss the consequences if the 2016 election for low interest rates.

One note on the chapter's U.S.-based focus. While the politics and history described below focus on the Federal Reserve, major central banks in other parts of the world are facing very similar dynamics. They have been billed as economically omniscient, but their tools for addressing the most pressing economic realities that affect retirees are limited.

As with so much else about the political environment, uncertainty clouds every informed discussion of the Fed's future—and the future path of interest rates—during the Trump Administration. Yet there are also dynamics at play that could push nominal interest rates down, not up.

### **The Fed's Role in Determining Low Interest Rates and the Forgotten Third Mandate**

The U.S. Congress created the Federal Reserve System in 1913 after a century of vast experimentation in the United States on nearly every aspect of banking and central banking. Today, the Fed has grown into something that its framers would not have predicted: it has become the regulator par excellence not only of the banking system, but of the macroeconomy itself. It has become, as former Fed Chair Paul Volcker once said, the 'only game in town.' Silber (2012: 201). This has led to the present moment, when the Fed has not only changed the way that banks are funded and regulated during and after financial crisis, but also how it has brought interest rates to historically low levels. Indeed the Fed is now in an unusual position for the Fed: while it has focused on fighting inflation and stabilizing employment, two of its statutory mandates, it has failed, for just the second time in its modern history, to deliver on its often forgotten third mandate: to maintain moderate long-term interest rates (See Figure 1).

*(Insert Figure 1)*

### **Why are Interest Rates So Low?**

Interest rates, are not simply low, but historically low. Moreover, this part of a longer-term trend that economist Mohamed El-Erian called the 'new normal,' coming out of the global financial crisis. El-Erian (2015). This is obviously true for short-term interest rates, which have hovered at or below the zero-lower bound in major economies since the Great Recession. But, as

Figure 1 illustrates, this is part of a longer trend for short-term interest rates, too. This observation then prompts a new question: why?

Most economists (and certainly central bankers) will argue that the Fed has little to do with this phenomenon. The Federal Reserve has remarkable authority in controlling short-term nominal interest rates by deploying its balance sheets in a variety of different credit markets. But as former Fed Chairman Ben Bernanke wrote in 2015, ‘real interest rates’—the rates most relevant for long-term investment decisions—are determined by a wide range of economic factors, including prospects for economic growth—not by the Fed.’ Bernanke (2015).

The problem is that the Fed controls nominal interest rates, and usually the nominal short-term interest rates at which banks lend to each other. Yet it has much less control over what is often called the ‘Wicksellian interest rate,’ or the real interest rate consistent with full employment of labor and capital, named for Swedish economist Knut Wicksell who first theorized the concept in 1898. Wicksell (1936/1898). The idea that the Fed is as much a victim of these trends as the rest of us stems from the idea that the factors determining the full deployment of labor and capital are not for the Fed to decide. Instead, they are a consequence of technological innovation, demographics, even culture, and certainly governmental fiscal policy, social policy, and the robustness of the financial system. In other words, the Fed as the monetary authority has one not-very-useful instrument, namely the short-term nominal interest rates. This instrument cannot dictate the Wicksellian interest rate unilaterally; the best the Fed can do is nudge nominal interest rates toward its estimated Wicksellian rate layer. Indeed, once we focus on that real rate—that is, the interest rate minus inflation—the graph would look even worse. If this view is true, then again the question becomes: why?



One explanation comes from a Depression-era theory from Alvin Hansen, one of the economists who first operationalized Keynesian macroeconomic theory. Hansen (1938). In the middle of the second of the two severe recessions of the 1930s, Hansen hypothesized that the equilibrium interest rate was so low not because of the sudden, idiosyncratic collapse of aggregate demand a la Keynesian theory, but because of something deeper. His analysis of the situation has gained influence lately, but mainly through summaries offered by others. Hansen's original perspective is worth citing in full (Hansen 1939: 4):

The business cycle was par excellence the problem of the nineteenth century. But the main problem of our times, and particularly in the United States, is the problem of full employment. Yet paradoxical as it may seem, the nineteenth century was little concerned with, and understood but dimly, the character of the business cycle. Indeed, so long as the problem of full employment was not pressing, it was not necessary to worry unduly about the temporary unemployment incident to the swings of the cycle. Not until the problem of full employment of our productive resources from the long- run, secular standpoint was upon us, were we compelled to give serious consideration to those factors and forces in our economy which tend to make business recoveries weak and anemic and which tend to prolong and deepen the course of depressions. This is the essence of secular stagnation—sick recoveries which die in their infancy and depressions which feed on themselves and leave a hard and seemingly immovable core of unemployment.

From Hansen's perspective, then, all recoveries would be weak because something fundamental had changed about the economy. It wasn't a problem of depression; it was a problem of productivity and demographics.

No economist has done more to bring Hansen's perspective back to the debate about the 'new normal' than Harvard economist Lawrence Summers. From his view, Hansen's theory was right, but untimely: 'Hansen turned out to be completely wrong but completely wrong in a way that suggests that at some future point he could turn out to be right.' Summers (2016: 96). Today, then, the anemic recovery from the financial crisis of 2008 and the subsequent recession is

what we should expect. Low Wicksellian rates are a more-or-less permanent feature of the landscape. Productivity, from this perspective, are a thing of the past.<sup>4</sup>

As far as economic theory goes, the idea of an equilibrium rate over which the Fed has little control is mainstream, even for critics of the Fed's monetary policies. The idea that we are in a period of secular stagnation is not.<sup>5</sup> Yet these debates miss a much more important point when we consider the Fed's role in determining the interest-rate environment. The question is not only 'What is the relationship between the Fed and low interest rates?' but, instead, 'How does the public perceive the relationship between the Fed and low interest rates?'

The answer to the first question is the theoretical and empirical question that occupies economists and central bankers; the second is the question of paramount political importance for those who will control the Fed's future. And that second answer takes a very different view of interest rates that is widely accepted in the public, the result of a long-standing public education program by the Federal Reserve, extending over decades, that has taken firm root in law, political discourse, and culture. That view has made it difficult to sell the Fed's own efforts to disclaim responsibility for low interest rates will be.

Public perception of interest rates pays little attention to the distinctions between an equilibrium rate and the nominal rate, the latter of which the Fed does in fact control. The mechanism the control has an obvious economic logic, as basic as a supply-and-demand graph from introductory economics. Here, the supply and demand are supply *of* and demand *for* short-term bank loans, a kind of good for which there is a market, just as there are markets for crude oil, pineapples, or squirrel traps. The price of money in these markets is the interest rate, here the Fed's federal funds rate. When the Fed makes money less available to banks to lend to each other, they will pay more for it, and interest rates will rise. When there is more money, people will pay less

for it, and interest rates drop. Thus, while the difference between the federal funds effective rate and the federal funds target rate is actually more complicated than this simple explanation suggests, the basic reality is that the Fed can and does affect interest rates through open market operations similar to the process described above: by affecting the availability of money, the Fed changes the price of money.<sup>6</sup>

When the availability of resources controlled by the central bank dictates the value of interest rates, the price-theory of nominal interest rates is economically accurate. Yet it is not helpful for understanding the nature of the equilibrium rate. While this difference may not matter much for economic theory, confusion between the two is a ubiquitous feature of public discourse on the Fed, interest rates, and public accountability. At a 2013 hearing, for example, Republican Senator Bob Corker lambasted Federal Reserve Chairman Ben Bernanke on exactly this theory: the Fed's continued decision to keep interest rates at the zero lower bound had 'thrown seniors under the bus.' People living on fixed income and depending on more robust interest rates, the Senator said, were run over by the Fed's monetary policies, apparently in service of policy oriented more toward younger generations.<sup>7</sup> Bernanke didn't appreciate the implication, but the idea that the Fed is responsible for the level of moderate long-term interest rates cannot be blamed on any given Senator. Rather, it is written in the Federal Reserve Act itself, in the Fed's 'mandate'.

The idea of a mandate for central banks is an old one, yet in the U.S. found its way into the Federal Reserve Act only in 1977. At that point, the U.S. Congress amended the Federal Reserve Act to give the Fed's marching orders. The revised statute is worth quoting in full, largely because it has become a classic in the Mark Twain sense: it is cited often, but never read. The 'mandate' requires (12 U.S.C. 225a):

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

When discussing what the Fed does, it is almost always reduced to a 'dual mandate' of 'price stability' and 'maximum employment.' As Janet Yellen put it (2017: 1), 'Nearly 40 years ago, the Congress set two main guideposts for that task--maximum employment and price stability. We refer to these assigned goals as our dual mandate.' But the statute was broader as it included an important third mandate: 'to promote effectively the goal[] of . . . moderate long-term interest rates.'

By nearly any definition, the Fed is now failing at that charge. Interest rates at the zero-lower bound are not moderate, no matter how one defines 'moderate.' Again, most economists and most central bankers would say that it has no control over this factor. But the failure is important because, whether true or not, the Fed is perceived by its congressional masters as not only having that power, but having the legal duty to use it. When the legal authority is put in these terms, the relevant question for the Fed and its long-term interest rates is not whether the Fed can unilaterally raise rates. Instead, the question is why does the public believe the Fed has this ability at all? And for that, we must turn to Fed history.

### **The Fed's Political Independence in History<sup>8</sup>**

Although the Fed's mandate was provided through a political system, it remains jealous of its prerogatives for determining how to pursue them. In the important conceptualization offered by economists Guy Debelle and Stanley Fischer, the Fed has 'instrument independence,' not 'goal independence,' (Debelle and Fischer 1994). To prevent the Fed's goals from becoming inordinately politicized, the bank relies on this instrument independence, a loose term that is

frequently invoked but rarely explained. In economics, and to a lesser extent political science, the concept of central bank independence has been so extensively studied as to earn its own acronym: CBI.<sup>9</sup> In 2004, Alan Blinder, an academic and former central banker, called the study of central bank independence a ‘growth industry,’ and the growth has only accelerated in the years since (Blinder 2004).

Although there are about as many definitions of central bank independence as there are authors who describe it, we can gather from these studies a rough consensus of what central bank independence means in reference to the Federal Reserve. The consensus goes something like this. Fed independence is the separation, by statute, of the central bankers (specifically the Fed chair) from the politicians (specifically the president) for purposes of maintaining low inflation. The idea is that citizens in a democracy naturally prefer a prosperous economy. Politicians please us by giving us that prosperity, or at least trying to take credit for it. But when there is no prosperity to be had, politicians will resort to supporting the economy artificially by running the printing presses to provide enough money and credit for all. The short-term result is reelection for the politicians. The long-term result is worthless money that wreaks havoc on our economic, social, and political institutions.

Several widely-invoked metaphors of central banking come tumbling forth: in the Homeric epic the *Odyssey*, when Odysseus—referred to in central banking circles by his Latin name Ulysses—ventured with his men close to the seductive and vexing sirens, he devised a scheme to allow his men to guide their ship past their seduction in safety, while he experienced the short-term joys of hearing their songs (Elster 1977). Central bank independence is our ‘Ulysses contract.’ We write central banking laws that lash us (and our politicians) to the mast and stuff bees-wax in the ears of our central bankers. We enjoy the ride while the technocratic central bankers guide the

ship of the economy to the land of prosperity and low inflation. (The public, by the way, represents the sirens in this metaphor.)

The other-commonly invoked metaphor is even more colorful. In the oft-repeated words of William McChesney Martin (1985), the longest serving Fed chair in history, the Federal Reserve is ‘in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up.’ The subjects of the metaphors differ by millennia, but the idea is the same: the partygoers and Ulysses alike want something in the near term, that their best selves know is bad for them in the long term. Central bank independence is the solution.

It is the last feature of the Ulysses/chaperone conception of independence that matters for our understanding the Fed’s ‘new normal’ of long-term low interest rates: the idea that the Fed can use technocratic expertise to accomplish its goal of price stability. This notion of Fed independence, and the reasons for it, are so entrenched in the academic and public imagination that deviations from it present complications even in the Fed’s own self-image, to say nothing of how the Fed is perceived externally. And now, when the Fed appears to be pursuing a policy of keeping interest rates *low* rather than raising them *high*, then the Ulysses/chaperone model starts to fail.

To understand this dynamic, and where it came from, we need to know more about why the Fed was created and how it changed over time. A conventional retelling of the Fed’s history is that it was a response to the problem of JP Morgan’s mortality. There was a financial panic in 1907, as there had been so many times throughout the 19<sup>th</sup> century, and, as he had before, Morgan—the famous head of a banking dynasty—had stepped in to save the day. Afterward, the public and members of Congress decided to do what they had failed to do before: create a central bank that would endure.<sup>10</sup>

The real story of the Fed's founding is much more complex than this. The time between the Federal Reserve Act of 1913 and the panic of 1907 made a big difference for the shape the Fed ultimately took, including the strange relationship between the Federal Reserve Board and the twelve quasi-autonomous Federal Reserve Banks. But most important for understanding the current context of low-interest rates was the political constituencies for having a central bank at all. Farmers and others likely to be chronically indebted were hostile to the idea of banker control over currency and its value; bankers, on the other hand, were not.

Our understanding of the structure of interest rates and central bank influence over interest rates was different, in large part because the world was different. Then when the Federal Reserve Act was first passed, the United States was on the gold standard and seeking to gain access to international markets also on the gold standard (Broz 1997). As the Fed transitioned to playing a greater role in setting national and international macroeconomic conditions, the perception of its role changed, too.

Perhaps the greatest influence on the of the public perception Fed was William McChesney Martin, Jr., Fed Chairman from 1951-1970 and author of the 'chaperone' conception of the central bank role. Martin came to the Fed with a long familiarity with its operations, as his father was the Governor of the Federal Reserve Bank of St. Louis. The son had also worked as president of the New York Stock Exchange in the late 1930s, and then as president again of the Export-Import Bank. By 1951, he was the Assistant Secretary of the Treasury for monetary affairs in the Truman Administration.<sup>11</sup>

It was an interesting time to be at the Treasury. The U.S. had recently discovered that the Soviets had successfully tested an atomic weapon, three years sooner than American estimates. Conflict on the Korean peninsula threatened to plunge the world once again into global war. And,

most importantly for understanding the Fed's political constraints, it was a time of intense conflict between the U.S. Treasury and the Federal Reserve. The Fed had been subsidizing U.S. government securities since the beginning of World War II and was agitating to stop. The Treasury wanted the subsidy to continue, and refused to budge.

Eventually, conflicts came to a head, but not after President Truman summoned the Federal Open Market Committee, for the first and last time in history, to the Oval Office to berate it. With Martin as the Treasury's lead negotiator, the Fed and Treasury reached what came to be called the Fed-Treasury Accord of 1951. The Accord was a public announcement that the Federal Reserve and Treasury had agreed that the Treasury would no longer dictate to the Fed the interest rates that Treasury would expect the Fed to support in the public markets. For many, this is considered a 'major achievement' in American history. Meltzer (2003, 711). In fact, however, the Accord did not do much on its own: it was just a single-sentence announcement. Here it is in full (Board of Governors 1952: 1):

The Treasury and the Federal Reserve System have reached full accord with respect to debt management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.

All this statement says is that the Fed and Treasury agreed that the twin aims of 'successful financing of the Government's requirements' and the minimization of the 'monetization of the public debt.'

Probably as part of the Accord itself, Fed Chairman, Thomas McCabe, stepped down and Martin replaced him. But soon, Martin took a very different approach to his role and sought not only to balance those two goals, but declared the Fed independent of the Treasury for purposes of determining monetary policy completely. President Truman, once



Martin's patron, now looked at him very differently. On Martin's report, at their next meeting at an event at a New York City hotel, Truman had but one word to say to the affable Martin: 'Traitor!' (Bremner 2004: 91).

Given that so little was determined by the Accord itself, Martin had to use his own leadership to fill in the gaps. Martin accomplished this in various ways, but one of the most important was not through market intervention or political fighting, but by language. It is hard to overstate Martin's love for metaphors: his public speeches are full of them. The chaperone language was not his only enduring image. He also stated that, 'lean against the winds of deflation or inflation, whichever way they are blowing.' He also argued that the economy was like a river: the Fed's aspiration was for money and credit to 'flow . . . like a stream. This stream or river is flowing through the fields of business and commerce. We don't want the water to overflow the banks of the stream, flooding and drowning what is in the fields. Neither do we want the stream to dry up, and leave the fields parched.'<sup>12</sup>

In practice, Martin was able to use this kind of language to thwart efforts to trim the Fed's sails or be bullied by politicians. After he had accepted one of Lyndon Johnson's infamous invitations to tour the President's Texas ranch at blistering speeds with Johnson driving recklessly, Martin took the opportunity to point out a large boulder interfering with the flow of the river on the property. Martin explained to Johnson that raising the discount rate was like removing that boulder: it would let credit, like water, run more smoothly. When Martin recounted the exchange to Fed staffers, they quickly corrected the Fed Chairman: that's not how discount rates work. Martin (1985: 1) responded: 'Well, it did this time.'<sup>13</sup>

Another metaphor was the idea that the Fed could take away the punch bowl, and also to decide who should be drinking and when. Central bankers' insistence on their ability to execute

this strategy meant, in time, that there was a trust that the Fed would be able to resolve the time inconsistency problem very easily, and always in the direction of the uncomfortably higher interest rates. This conception stands in painful contrast to Bernanke's insistence on Wicksellian interest rates and the central bank's inability dictate interest rates to the economy. Later historical developments in Fed history—the fall of Arthur Burns and the rise of the Great Inflation, Paul Volcker and the skyrocketing interest rates that finally broke inflation's back, Alan Greenspan as the 'maestro' economic tinkerer without peer—only added to the perception of omnipotence.

The financial crisis of 2008 was another historical watershed for the Federal Reserve, for many reasons. First, the crisis brought the Fed front and center to the public's attention in ways largely unfavorable. Second, the idea that the Fed bailed out Wall Street through the extraordinary deployment of billions of dollars took root in the public's mind, and not favorably. In other words, the Fed's unconventional monetary policy actions in the aftermath of the crisis occurred when everyone was watching which prompted a populist backlash not anticipated by Martin's conception of Fed independence. Instead of insisting that the Fed leave the punch bowl on the table, the populist protestors were *opposed* to low interest rates. The debtors who would benefit most from artificially low interest rates were either silent during the political debate, or they misunderstood the ramifications of the Fed's policies. So it was that Texas Governor and presidential contender Rick Perry in 2011 lambasted the Fed with violent imagery (Zeleny and Calmes 2011: 1): 'Printing more money to play politics at this particular time in American history is almost . . . treasonous,' he said. 'I don't know what y'all would do to him in Iowa, but we would treat him pretty ugly down in Texas.'

The simultaneous depiction of the Fed as controlling interest rates and using them to abuse those who would require a higher return on their investments is, then, a deeply rooted one. My

point is that the Fed itself was the author of this public idea and drove it deeply into the public psyche in the service of preserving its independence. Now that it requires public support for the *opposite* reasons, that support will be difficult to come by. The political alliances that have previously supported the Fed were built on a notion that does not apply when the equilibrium rate is low.

### **The Fed During the Trump Administration**

Prior to the U.S. presidential election, the prevailing view was that Donald Trump was too toxic to too many political constituencies to win the general election. In central banking circles, the debate about the equilibrium rate was focused on the question of secular stagnation, not on the inflationary pressures that fiscal policy can create.

What a difference a presidential election made! The election of 2016 was a defining moment for the Federal Reserve, with potent consequences for both real and nominal interest rates. For real interest rates, if the Trump Administration adopts policies that change the underlying nature of the investment climate and the productive deployment of labor and capital, then the equilibrium rate could rise again. The equity markets, at least initially treated the election as indicative of accelerated growth, with only modest increases in inflation expectations.

How nominal interest rates develop will be a more interesting dilemma. The Fed has accelerated its campaign to tighten interest rates, a process that began in December 2015. If the Fed's expectations are to be heeded—and to be clear, these projections have been chronically off-target—then we should expect to see a federal funds rate in the 3% range by 2019 date.

Yet many factors are at play. Not least is how the Fed will be reshaped during the Trump Administration, since he has the opportunity to fill several vacancies on the board. Every president

has the statutory and constitutional right to make these appointments and uses them to influence his agenda. Trump will be no different.<sup>14</sup>

Predicting President Trump's agenda is no easy matter. In the past, presidents of both parties generally favored central bankers who lowered interest rates for reasons the Ulysses/Chaperone conception of Fed independence anticipated: it's helpful to win elections and preserve legacies if the economy is booming, even if that boom is only on the back of cheap currency. Yet during the Obama Administration, Republicans consistently criticized the Fed for these very low interest rates. It is unclear whether the Trump coalition will pursue more hawkish monetary policy, consistent with those 2009-2016 critiques, or favor presidential prerogatives, as has been historically true.

Appointments, though, are not the only mechanism that presidents have for influencing the Fed. The other mechanism, used by presidents throughout history, is to deploy the many non-legal mechanisms at a president's disposal to influence central bankers. Regardless of whom President Trump appoints to succeed Janet Yellen as Fed Chair when her term expires, he may develop strong ideas about the appropriate direction that interest rates will take. If the Fed engages in tightening interest rates to cool the economy, he may seek to impose political constraints on the Fed preventing it from moving too quickly. In that case, the Fed's nominal interest rates may undershoot the equilibrium rate—and in the process, cause an overheating economy to trigger inflation. If that occurs, it will in fact be the Fed—not the economy—that is keeping interest rates artificially low.

## **Conclusions**

This chapter argues that the Fed's status as the 'chaperone' given independence by Congress for the purpose of constraining inflationary fiscal policy has backfired during times when

the Fed has pursued the opposite tack. A Fed trying to keep the party from getting out of control is an image of an omnipotent central banker that has taken hold in the public imagination in a way that few if any governmental agencies can match. That's a different image altogether is that of a Fed trying to get a bunch of wallflowers to take tequila shots.

It is little wonder, given the decades-long effort to construct an inflation-fighting central bank, that this abrupt change has caused so much backlash. And it is not enough, to claim that the public's misunderstanding on these issues reflects a burden that the public itself must correct. The law requires the Fed to pursue moderate long-term interest rates, in an almost always-forgotten third mandate. In any event, the reason the public believes the Fed is an inflation fighter is that the Fed and central bankers who work within it have been pushing this argument for decades.

Historically, this defense of the currency against inflation has put retirees as staunch defenders of an independent central bank. A world of low interest rates credited to the Federal Reserve removes this support. Few groups feel the effects of these rates more profoundly than those who depend on more robust interest rates for their economic security. As other authors in this volume have highlighted, the investment environment for low interest rates requires dramatic changes (Wallick et al. 2017).

The Fed has become a victim of its own success. The Fed's ability to affect the equilibrium rate that reflects the fullest deployment of labor and capital is not absolute, nor even very strong at all. Moreover its control over nominal interest rates is important but often exaggerated. The Trump Administration may play a decisive role in determining how nominal and real interest rates interact, as well as how activist Fed policy and underlying economic realities intersect. Should the President seek to appoint (or, regardless of appointment, influence) central banking policy to be more consistently accommodative than the equilibrium rate suggests, then inflation will be the

consequence and the secular trend of low interest rates will become artificial, precisely as the Fed's critics have argued has been true for years. As we look, then, to the future of monetary policy, the question about central banking control and chronic low interest rates will be as much political as it is economic.

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## Endnotes

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<sup>1</sup> For comparisons between Jackson and Trump, see Baker (2017).

<sup>2</sup> For more on Jackson and the Second Bank of the United States, see Howe (2008).

<sup>3</sup> For more on the Fed's political role, see Kaiser (2013). For the Fed's ability to gain authority after crisis, see Shull (2005).

<sup>4</sup> For the deep historical perspective, see Gordon (2016).

<sup>5</sup> For the strongest counterpoint to secular stagnation, see Hamilton et al. (2015).

<sup>6</sup> This paragraph borrows from arguments I made in Conti-Brown (2016, 134).

<sup>7</sup> See Davidson (2013) for coverage of the hearing.

<sup>8</sup> Portions of the first two paragraphs in this section appeared in Conti-Brown (2016: 2).

<sup>9</sup> For a recent review of this extensive literature, see Fernández-Albertos (2015).

<sup>10</sup> For more on this origin story, see Lowenstein (2015) and Bruner & Carr (2009).

<sup>11</sup> Bremner (2004) is a superb biography of Martin.

<sup>12</sup> Interview in U.S. News and World Report, Feb 11, 1955, 56.

<sup>13</sup> As recounted in Bremner (2004: 211).

<sup>14</sup> Chang (2003) provides an excellent overview of the dynamic between President, Congress, and the Fed at the appointment level.



**Figure 1.** Ten year treasury constant maturity rate

*Source:* Board of Governors of the Federal Reserve System (2017).