The Independence of the Federal Reserve During the Trump Presidency: An Ethical Analysis

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Abstract: An analysis using the utilitarian method, backed by quantitative data and qualitative observations, supports the ethical argument for the Federal Reserve remaining independent of the US President to make sound decisions on behalf of its citizens. We have reasons to justify that the Fed's decision to raise interest rates – made independently and without political motivation – is the best possible choice from a utilitarian standpoint because such independent decisions improve the economy as whole and provide the greatest benefit for the greatest number of people.

Introduction

On July 19 and October 10, 2018, President Donald Trump expressed disapproval of the Federal Reserve's decision to raise interest rates, claiming that he's "not thrilled" and it had "gone crazy" with policy in interviews with CNBC and the media (cnbc.com). On July 20, he tweeted further condemnation of the Fed, claiming the central bank's shift towards monetary tightening would only negate the effort of his administration to promote economic expansion. This move to control the Fed comes on the heels of the Fed's recent interest rate hike from 2.0 to 2.25 percent in September. In the following paper, I suggest Donald Trump overstepped Presidential boundaries by attempting to influence the Fed's decisions. Trump's politically-charged rhetoric is a form of manipulation of the Federal Reserve that impinges on the institution's necessary independence from the Federal government.

Thankfully the Fed – led by chairman Jerome Powell – seems to have ignored the President's pointed commentary and refused to give in to his veiled demands to keep interest rates low. Although current interest rates were held steady at the Federal Open Market Committee meeting on August 1, there was a hike in interest rates on September 26 (cnbc.com). It remains to be seen if Trump will continue to seek control over the Fed and what if any affect his criticism will have on its future economic policy decisions.

To Raise or Not to Raise

The decision of the Federal Reserve to raise interest rates is related to the current economy's inflation rate. Interest rates reflect the amount charged by lenders to borrowers. Inflation is the increase of prices for goods and services over time; when inflation occurs, the purchasing power of a unit of currency begins to fall (howstuffworks.com).

The pattern of raising and lowering interest rates moves in a cycle that reflects the overall state of the economy. When the economy is recessionary, demand is low relative to supply. The Fed will choose to lower interest rates in order to stimulate economic growth; the greater availability of money will increase demand by encouraging business investments and consumer spending. Conversely, when the economy is booming, inflation will begin to rise as demand exceeds production levels. While inflation is not necessarily bad, an overinflated economy can be dangerous. When the government prints too much currency, production costs rise, driving up final costs to consumers who can no longer afford to support businesses (sciencing.com). If rising prices and a rising inflation rate become worrisome, the Fed will choose to step in and raise interest rates to curb inflation.

The Fed typically aims for a 2 percent inflation rate. According to the central bank, this is the ideal rate to maintain maximum employment and price stability. A higher inflation rate would lead to problematic inflation. Meanwhile, a lower rate potentially engenders deflation, the falling of prices for goods, services, and wages, which indicates a weaker economy (federalreserve.gov). The present US economy is in an inflationary state and continues to be strong. Second quarter GDP in the US was 4.2 percent, while third quarter GDP declined to 3.5 percent, which is high compared to the usual 2 to 3 percent. Recent trends also suggest the inflation rate will continue to rise in the coming months if left unchecked. According to the latest measurements, as of June, the inflation rate is at 2.87 percent. This is the highest it has been since 2013 (inflationdata.com). Thus, it makes perfect sense for the Fed to begin raising interest rates in the coming months to prevent excessive inflation.

Evidence for Independence of The Federal Reserve

There is strong evidence to support an independent Federal Reserve. In a seminal 1993 paper, economists Alberto Alesina and Lawrence H. Summers analyzed economic data from 16 different countries including the US that had varying levels of government control over their central banking institutions. Alesina and Summers' research offered clear empirical data that countries whose central banks were politically controlled including New Zealand and Spain had higher inflation rates. Conversely, countries with independent central banks including Germany and Switzerland showed lower inflation rates that had little impact on their unemployment rates. (debis.deu.edu.tr).

In 2014 former Federal Reserve Vice Chairman Donald L. Kohn suggested that the Federal Reserve was no longer independent due to actions taken by the federal government in the wake of the 2010 financial crisis. Instead, per Kohn, it was becoming dangerously politicized to the detriment of the economy. Kohn listed four primary factors affecting the Fed's independence: political polarization, Dodd-Frank cutting Fed powers, political pressure following interest rate hikes, and the Fed's additional responsibilities to promote unpopular economic policies in order to prevent a financial crisis. In his research, Kohn echoed the findings of Alesina and Summers using recent evidence that countries with independent central banks have more stable inflation rates with no sacrifice on employment or income. (brookings.edu, federalreserve.gov).

Historical Precedents

The argument for Fed independence is also supported by circumstantial evidence from the failures of past Presidential attempts to tamper with monetary policy. Trump is not the first US president to openly criticize and even dangerously redirect the decisions of the Federal Reserve. In 1972, Richard Nixon notably attempted to control the actions taken by the Federal Reserve for his own gain, resulting in an economic disaster that lasted nearly a decade cite. History provides a normative justification for why presidents and politicians have no business becoming involved in monetary policy.

Nixon and Stagflation

Leading up to the Presidential election of 1972, Republican candidate Nixon sought to entice voters with the promise of a strong economy and a low unemployment rate. In order to do so, Nixon chose to replace then-chairman of the Federal Reserve William McChesney Martin with his own appointee, the more politically malleable Arthur Burns. Nixon later leveraged his influence over Burns as the new chairman of the Fed by pushing him to keep interest rates low in a bid to maintain a lower unemployment rate. According to economics professor Burton A. Abrams, the released Nixon tapes revealed several conversations between the president and Burns in which Nixon can be heard pressuring Burns to keep rates low, even saying "we'll take inflation if necessary, but we can't take unemployment" (businessinsider.com)

Unfortunately, Burns caved to Nixon's self-serving demands and did keep interest rates relatively low. This move was problematic as the US economy was facing an excessive average annual inflation rate of 6.2 percent. By 1973, the Fed was forced to raise the target fed funds rate 21 times over the course of the year. This attempt to curb inflation eventually caused the economy to stall, thereby engendering a period of stagflation. Under stagflation, the economy suffered high unemployment, high inflation, and low economic growth. This economic malaise lasted until roughly 1979 when the new Fed chairman Paul Volker dramatically increased interest rates effectively ending the extreme inflation of the Nixon era (theguardian.com).

Other Cases of Criticism

In more recent years, other Presidents have offered tempered criticisms of the actions taken by the Federal Reserve and the Fed chairman. For example, in a now infamous 1998 televised interview with David Frost, President H.W. Bush blamed former Fed chairman Alan Greenspan for the loss of the 1992 presidential election to Bill Clinton. Bush claimed that Greenspan's reluctance to quickly lower interest rates during the recession between 1990 and 1991 led to further economic downturn. He suggested this factor negatively impacted how voters perceived his economic record in the election (wallstreetjournal.com).

An Analysis of Trump's Commentary

As to be expected, media pundits, academics, and economists alike have begun to make predictions about how Trump's recent commentary will potentially impact the Fed's policy decisions. Two major camps seem to have emerged in the debate. Some view the interaction between Trump and his own appointee Jerome Powell as a reminder of Nixon and Burns and fear a return to the past. Others argue there is little that Trump can do and the Fed is still relatively insulated from the partisan political sphere.

Potential Threat to Independence

There are some indirect powers available to Trump that he can potentially employ to further manipulate the Fed's decisions. According to the Federal Reserve Act, the President can "remove governors including the Fed chairman "for cause". Still, it is unclear what this vague language implies as a modern President has yet to fire the Fed chairman. Instead, a more pressing concern is that because Presidents do pick their own appointee when the term of the incumbent ends, the current Fed chairman will always be politically indebted to the president. So far, Powell seems content to defy Trump, but if Trump continues his barrage of criticism, Powell may yet cave in to political pressure as Burns did.

The president also has the ability to appoint governors to the Washington Fed board. These seven appointed officials have an important influence on the voting behaviors of the twelve member Federal Open Market Committee (www.bloomberg.com). Trump may have better luck influencing his appointees who can leverage their powerful voting block to redirect the Fed's actions as Trump sees fit.

Limitations on Trump's Influence

Still, most insiders and traders seem to back the notion that the Fed is an independent institution and that therefore, Trump's comments will have little to no impact on Powell's decisions. The initial market reaction indicates that traders are continuing to assign a high probability to the Fed's predicted interest rate hikes in December. For example, the fed funds futures market – where traders bet on the Fed's moves – showed no movement following Trump's comments. The CME Group's FedWatch tracker predicted on July 20 a 91 percent chance of a hike in September and a 61 percent chance of one in December (www.cnbc.com)

Others have pointed out that Trump, even as President, is incapable of truly altering the Fed's decisions. Ultimately, the President does not have any "sign-off" authority on Fed policy. Instead, the Fed typically sets policy without Presidential interference, and its final decisions do not require any form of lawmaker approval. The Fed's regional voters are also shielded from partisan politics. Their districts select them, and only the Fed Board can veto their appointments. Furthermore, even though the Inspector General watches over the Fed, the Fed's budget is not appropriated by Congress. All of these factors indicate the Fed is still an independent institution that operates outside of the Federal government's domain (www.bloomberg.com).

Ethical Analysis: The Utilitarian Justification For Independence

A utilitarian framework can be used to ethically evaluate Trump's encroachment on the Fed's independence based on the predicted effect the choice to follow his pronouncements will have on the future state of the economy. The doctrine of utilitarianism loosely states that actions are normatively justified insofar as they produce the greatest good for the greatest number of people (britannica.com). The term "good" for the purpose of this analysis can be quantitatively defined by financial gain or loss on an individual basis. If we think that, by following Trump's advice, the Fed's course of action will have a positive impact that will boost the overall economy and lead to financial gains for citizens, then arguably Trump's involvement in the Fed's decision making is justified. However, if we think that his commentary will lead the Fed to make a poor decision that will harm the economy and consequently reduce the economic welfare of citizens, then we have moral reason to support the Fed's independence.

We can examine the available data to predict how the economy will fare if the Fed were to act based on Trump's wishes and lower interest rates (inflationdata.com). As stated above, our economy is mildly inflationary, and thus lowering interest rates will likely increase inflation and eventually may even engender a period of Nixonian stagflation. In this case, a utilitarian calculus would suggest that based on the negative predicated economic outcome, citizens would only be financially hurt by Trump's involvement in the Fed's decisions.

Conversely, the data suggest the Fed's current choice to hold interest rates steady for the time being has yet to yield any negative economic consequences in terms of increased inflation. We can predict the Fed's decision to raise interest rates in the coming months as planned will have a neutral or even beneficial impact on the economy by controlling and curbing any excess inflation. A stronger overall economy will lead to increased financial gains for individual citizens. Based on an utilitarian calculus, no change at all with a promise of positive change – as a lower inflation level would indicate – outweighs the negative increase in inflation that Trump's plan to lower interest rates is predicted to cause. Even if the latest data continue to show that inflation rate has not changed, then we still have reason to support the Fed's ability to independently implement its current plan without following Trump's bullying.

The utilitarian argument for the Fed's independence is further corroborated by the findings of Alesina and Summers as well as historical examples of past US Presidents' misguided attempts at controlling the Fed. Alesina and Summers' research demonstrates that when Federal governments are too involved in the actions of their country's central banking institution, their citizens are financially hurt by dangerously high inflation rates. Similarly, we know that when Nixon exerted control by forcing the Fed to keep interest rates low, the subsequent inflation spiraled into stagflation. His efforts resulted in an economic recession that caused staggering losses for citizens.

Ultimately, the utilitarian cost-benefit analysis that is backed by both quantitative data and qualitative observations supports the general argument for the Federal Reserve remaining independent of the government and the President to make sound decisions on behalf of US citizens. Regardless of the intent behind his comments, the fact that Trump's economic vision is likely to cause financial losses indicates we have no grounds to normatively justify his actions in attempting to influence the Fed. Instead, we have more reason to think the Fed's decision to raise interest rates – made independently and without political motivation – is the best possible choice from a utilitarian standpoint that, by improving the economy as whole, does provide the greatest benefit possible to citizens.

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