View from the Beltway

Washington's Last Bastion of Nonpartisanship

By Owen Ullmann

But did the Fed staff receive the news?

The bitter partisan polarization gripping the United States is acting like a virus that has infected government institutions designed to avoid such schisms so they would act in the best interests of all citizens. Congress has long been Ground Zero for partisan gridlock, and that affliction has spread to the Supreme Court, whose recent rulings have revealed a sharp ideological divide. Even the FBI, with its fabled "G men," is being accused of partisan bias in the wake of the raid of former President Trump's Mar-A-Lago estate in Florida.

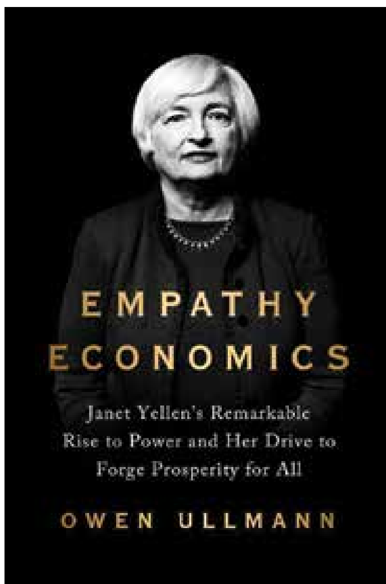
Could the Federal Reserve be next? So far, the nation's central bank has avoided being tarnished as just another partisan government agency. And if it succeeds in tamping down inflation over the next year, even at the cost of a recession, it will retain its reputation as an independent institution driven by economic goals rather than a Democratic or Republican agenda.

Janet Yellen has emerged as Powell's protection.

Certainly, when it comes to the conduct of monetary policy, there is little evidence of partisan politics driving interest rate decisions. Fed Chair Jerome "Jay" Powell and company are moving aggressively to combat a spike in inflation without regard for the impact on the Biden administration and Congress heading into a critical midterm election. Powell underscored that commitment with a hawkish speech at the Fed's annual Jackson Hole conference on August 26, when he vowed to keep raising rates until inflation is vanquished, though that will entail economic pain.

True, the Fed's interest rate hikes this year at the fastest pace in its history were needed to make up for its slow start in tackling rising inflation. Last year, an egregious staff forecasting error led Powell to assume a jump in prices was "transitory." As a result, the Fed continued stimulating economic growth to ensure the economy was on sturdier legs in the aftermath of the collapse triggered by the Covid-19 pandemic in the spring of 2020.

Now that the anti-inflation campaign is underway, Powell has been encouraged to focus on bringing



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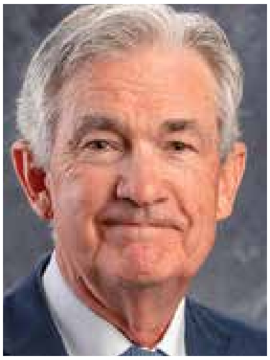

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inflation down by his chief patron and protector in the administration, Treasury Secretary Janet Yellen. As his predecessor in the job, Yellen has counseled the Fed chair to try to ignore the short-term partisan repercussions and aim to restore the economy to healthy growth with price stability. The Treasury secretary worries the job market is too tight to restrain inflation and the Fed will have to push unemployment into the 4 percent-plus range, maybe even to 5 percent, to succeed.

Yellen's views on this matter because she convinced President Biden to re-appoint Powell last fall over opposition from many in the Democratic Party's left wing, and no one in the administration has her clout when it comes to monetary policy.

Powell also has enjoyed full backing for his hawkish rate hikes from the Federal Open Market Committee, including Vice Chair Lael Brainard, who had been favored by many Democrats as Powell's replacement. Brainard served as undersecretary of the Treasury for international affairs in the Obama administration, and her husband, Kurt Campbell, is Biden's coordinator for Indo-Pacific affairs on the National Security Council. Despite those Democratic connections, Yellen, a friend and mentor of Brainard's, considers her to be a thoughtful straight arrow on monetary policy decisions.

That should not be surprising to Fed historians. Verbatim transcripts of FOMC meetings dating back to the late 1970s through 2016 (they are released at the end of each calendar year with a five-year lag) show spirited debates on economic forecasts and goals—such as how hard to tap the brakes on inflation without sending unemployment soaring—but not on partisan issues, such as the advantages or problems policy decisions pose for elected politicians.

"I don't think there's much evidence that partisanship *per se* permeates monetary policymaking at the Fed," said Sarah A. Binder, a senior fellow at the Brookings Institution and professor of political science at George Washington University. She is co-author with Mark Spindel of *The Myth of Independence: How Congress Governs the Federal Reserve* (2017). Still, she continued, "given that the Fed needs broad political support to make tough policy choices, a more polarized electorate and Congress complicate the Fed's ability to meet its congressional mandates" of price stability and full employment.

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Donald Kohn, a four-decade Fed veteran who rose from staff economist to vice chair of the Board of Governors, agreed that monetary policy has remained immune from partisanship. It was certainly the case during his years there until he left in 2011, and it appears to continue based on current appearances. "I don't recall in all my time on the Fed any partisan discussion when they voted on monetary policy," recalled Kohn, now a senior fellow at Brookings. "All the discussion was, 'How does this relate to our goals?' rather than 'How does this relate to the prospects of one or another party at the next election?' Even at meetings just before an election, there was rarely any talk about the election and how it might affect monetary policy. I attended FOMC meetings for something close to thirty years, and you don't know what's in someone's mind, but it's not a topic of discussion. And I've been there for transitions from the Reagan administration to Bush to Clinton and back to Bush."

Kohn's observations were echoed by economic consultant Lawrence Lindsey, who served on the Fed board in the 1990s and later was director of the National Economic Council for President George W. Bush. "The Fed has always had a political aspect to its decision making and I don't think that will ever go away because it is a creature of Congress, but I don't

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think it's an overtly partisan organization," Lindsey said. "It's as pristine as one could be in Washington on monetary policy."

While Lindsey praises board members for avoiding partisanship and ideological battles, he points a finger at a staff that he claims in recent years has developed a homogeneity of left-of-center views that produce chronic forecasting errors. "We used to have a lot of varying points of view in the staff, but that has largely disappeared," he said. "If you look at the economic projections, you will see an exceedingly tight range. No one is volunteering a view of the economy different from their colleagues, and that is not a good policy. Forecasting is worse now. The most obvious bias is that the staff consistently overestimate the efficacy of traditional dial-turning and lever-pulling macro policy driven by Washington, and consistently underestimate the importance of incentives and the micro part of the economy. They highballed Obama policy, they highballed Biden, and they lowballed Bush and Trump. It's not partisan, it's ideological. They are great believers in traditional Washington prescriptions and therefore they're going to naturally exaggerate their importance."

Lindsey also faulted the Fed for taking on inappropriate new responsibilities, such as the financial risks of climate change and economic inequality because of "woke" pressure.

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Adam Posen, president of the Peterson Institute for International Economics, said that view is widely held by many in the financial markets, which made many traders question whether the Fed will have the determination to keep up its anti-inflation campaign. "There was a lot of momentum built up behind the story that the Fed was behind the curve [on inflation] because they had gotten 'woke' and they were very worried about distribution and unemployment, which I think they were in a good way," Posen explained. "There is this ongoing momentum that people just insist they won't have the nerve to keep raising rates once we start seeing a recession. I don't think that's right."

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Posen speculated that prevalent doubts about the Fed's vow to quash inflation stem from the fact that the country is in the midst of a politically fragile situation. "Some people in the markets interpret that as infecting what the Fed is doing. And I think it's having some effect but nowhere near as big an effect as people seem to think. The Fed has a very straightforward mandate here, which is if inflation is out of control or is exponentially accelerating at a high level, nothing else matters." Posen is convinced the Fed will push the Fed funds rate above 4 percent if needed to ensure it succeeds in its anti-inflation campaign.

While monetary policy may be immune to partisan politics, other issues the Fed deals with often are not. These include bank regulation, consumer protection, and oversight of investments in minority communities. Republican appointees to the Board of Governors tend to favor less Fed intervention, while Democrats on the board generally vote for tighter supervision.

Princeton economist Alan Blinder, a Clinton appointee who joined the Fed as vice chair along with new governor Janet Yellen in 1994, remembered a clear political divide on these issues since he and Yellen were the only Democrats on the seven-member board, which was chaired by Alan Greenspan at the time. "Consumer protection was a big one where left-right perspectives differ much more than on monetary policy," he said. "There were any number of board votes at that time on regulatory issues that went five to two." Interest rate votes, by contrast, did not break down based on whether a governor was a Republican or Democratic appointee, he added. Indeed, Lindsey often voted on rate moves in unison with Blinder and Yellen. Lindsey also was an exception to the rule on non-monetary issues: he was a big believer in the Community Reinvestment Act, which requires the

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Fed to ensure that banks are providing adequate loans in lower-income communities.

Binder said the structure of the Fed board helps insulate it from partisanship. Governors are appointed for a single fourteen-year term, and the terms are staggered, though few governors stay on for all fourteen years. Most serve two to six years, which produces constant turnover that makes it difficult for one party's nominees to dominate the board for very long. In addition, the presidents of the twelve Federal Reserve Banks also rotate every year as voting members of the FOMC.

Historically, the Fed was created to be less isolated from partisan politics. From its start in 1914 until 1936, both the Treasury secretary and Comptroller of the Currency were members of the seven-member governing board, giving presidents during those years direct influence on policy decisions. Subsequently, as the Fed was restructured to be more independent from partisan interference, presidents sought other ways to exert influence. President Lyndon Johnson summoned then-Fed Chair William McChesney Martin Jr. to his ranch in 1965 and physically threatened him to keep interest rates low to help fund LBJ's Great Society spending program. Martin wouldn't back down. By contrast, President Richard Nixon pressured Arthur Burns to run an expansionary monetary policy leading up to Nixon's 1972 re-election campaign. Burns complied, either because he was cowed or actually considered it appropriate policy.

In the last four decades, Fed chairs have shown more independence from the presidents who nominated them and the presidents have refrained from trying to pressure them on monetary policy decisions—with a few notable exceptions. Ronald Reagan backed Paul Volcker's anti-inflation crusade, even at the price of a severe recession in 1981–1982, and renominated the Jimmy Carter appointee in 1983. George H.W. Bush publicly blamed Alan Greenspan's interest rate hikes for causing a recession in 1991 but still reappointed him Fed chair, as did Bill Clinton and George W. Bush. Barack Obama, who had earlier promised former Treasury Secretary Lawrence Summers the job, reappointed Ben Bernanke, who was originally chosen by the younger Bush and led the nation out of the Great Recession. Donald Trump broke with the tradition of giving a second term to a successful Fed chair when he replaced Yellen with Powell in 2018. He had complained privately to friends that Yellen was "too short" for such a powerful post, but he also had been lobbied by advisers and Senate Republicans to name someone less committed to strict financial regulation. Trump regretted the appointment almost immediately and huffed and puffed over about Powell's refusal to slash interest rates.

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"The fact that these chairs with some exception tend to get reappointed and often by a president of the other party, it's just very hard for these appointees to do the bidding of those who appoint them," Binder underscored. President Biden: take note.

All eyes are now on Powell's Fed to see how far it will go to defeat inflation and at what cost to the economy. Obviously, Democrats are rooting for a rare soft landing and Republicans would be happy with either continued high inflation or a recession going into Election Day. This is one of those moments that tests the Fed's economic abilities and courage to see the job through. If it succeeds in restoring healthy growth with low inflation in the near term without regard for the partisan fallout, it will continue to earn the support of Congress, the president, and most Americans, the current hyper-polarized climate be damned. ◆

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