

Goldman Sachs Exchanges

Is Fed independence at risk?

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Allison Nathan: President Trump's public criticism of the Fed isn't new. But in its second term, the Trump Administration is preparing to turn words into action. It's setting in motion a challenge to the precedent that has long prevented presidents from firing officials of independent agencies without cause. So, is the Fed's independence in jeopardy? And how much independence should the Fed have anyway?

I'm Allison Nathan and this is Goldman Sachs Exchanges. Each month I speak with investors, policymakers, and academics about the most pressing market moving issues for our Top of Mind report from Goldman Sachs Research. I recently spoke with former Fed vice chair Richard Clarida and the Hoover Institution's John Cochrane about the

independence question. I started by asking Clarida what Fed independence really means.

Richard Clarida: Congress created the Fed as what we call an independent agency in 1913 and intended for it to have a degree of independence. How so? First, Federal Reserve governors have 14-year terms. And they are appointed on a staggered basis so that governor terms come up only once every two years. The idea being originally that it would be difficult for any one president to appoint an entire board.

Secondly, Federal Reserve governors can only be removed for cause. And for cause has been interpreted by the Supreme Court as malfeasance, neglect, or dereliction of duty. So, essentially, the Congress intended for Fed officials not to be fired by the president solely because he disagreed with their economic policy. And importantly, that was actually upheld by the Supreme Court in 1935. So, it's both the statutory language and Supreme Court precedent since 1935 that Fed officials can only be removed for cause. And thus, that helps to insulate them from the political process.

Allison Nathan: So, in some sense it is a political

organization.

Richard Clarida: It is a creation of Congress. But the Fed has instrument independence, which is a fancy way of saying the Fed can raise or lower interest rates or buy and sell treasuries without political interference.

The Fed does not have goal independence. And so, the goals of monetary policy are set by legislation. And the goals of the Fed have changed over time by Congress. And so, in 1913 when the Fed was set up, the goal was to provide, quote, "an elastic currency to facilitate bank intermediation." And then over time it was recognized in particular after World War II that the Fed had an important role to play in overall economic performance.

And so, formalized in 1977 in an amendment to The Federal Reserve Act is the current reading of the Fed's mandate assigned to it by Congress which is, quote, "maximum employment and price stability." So, when we say that the Fed's goals are maximum employment, price stability, that's really the people's goals as articulated through legislation that's been enacted into law.

Allison Nathan: Cochrane also explained that the Fed's independence is not absolute.

John Cochrane: Fed independence is not written in the Bible as the 11th commandment; the Fed shall be independent. It is something invented by our policy system or by Congress for Congress' purposes. The Fed is independent. But what are the rules of the game? The Fed has a limited mandate. So, the Fed's job is inflation and employment.

And then when you say inflation, employment, you mean and nothing else. And a little bit of financial stability too. But your mandate does not include. Even if you think climate's the catastrophe coming, it's not your job. That's the price of independence. You can be allowed in our democracy to have great power if you confine it to the mandate.

Second, the Fed is confined by limited tools. It gets to set interest rates. But it is kind of funny, the Fed's job is supposed to be inflation. The most effective thing to do to create or to get rid of inflation is, say, if you want to create

inflation, you print money and you give it to people. Kind of what we did in 2021 to 2023. Rap. Works like a charm.

And the most effective way to limit inflation is to go out and take people's money away. That works like a charm too, that's called taxing and spending. But the Fed is not allowed to do it. Why? Because that's an intensely political thing, giving people money or taking their money away.

So, it's kind of funny. Here's the Fed charged with inflation. Yet the most important tool is denied. Why? That's the price of political independence.

Same thing, employment. The Fed is supposed to be in charge of employment. Well, if you want more employment, what's the most important tools? You can change the structure of unemployment insurance. Change the structure of social programs. Change labor laws. Improve the schools. All the things that are kind of getting in the way of employment. The Fed is not allowed to touch that. In fact, you know, your job is employment, and your tool is the Overnight Federal Funds Rate. So, limited tools and limited mandates are the price of independence.

Allison Nathan: Clarida says that this independence is important to produce better economic outcomes, especially lower inflation. And he's more concerned about threats to independence today than he was during his time at the Fed.

Richard Clarida: Well, Fed independence is very important in the very specific sense that history and academic research has shown consistently that an independent central bank produces lower inflation, less volatile inflation, but without any other tradeoff in terms of excessive financial or real volatility. So, in the day that it's the closest thing to a free lunch that you get in terms of economic policy.

Allison Nathan: Interesting, do you perceive any difference between Trump's attitude toward the Fed today versus during his first term?

Richard Clarida: That's a great question because at one level the answer is no. He's still being publicly critical of the Fed. He's also hinting, but when he's pressed, he says he has no intention of firing Jay Powell. The difference however is that the Trump 2.0 justice department is taking

the position that the Supreme Court case in 1935, which is called *Humphrey's Executor*, that the *Humphrey's Executor* case itself should be overturned because it represented an unconstitutional constraint on what's called the unitary executive idea of our Constitution.

And so, in Trump 1.0, they oftentimes said they were not happy with the Fed. But they never really pressed the case that they could if they wanted to remove a Fed official except respecting the for-cause standard. And the position in the current Trump Administration, I think at least with regards to the National Labor Relations Board is that the entire Supreme Court case which provides that precedent should be overturned.

Another interesting wrinkle here, Allison, is the Trump 2.0 administration is also taking the position that independent regulatory agencies need to get affirmative sign off from the White House on regulations. But they have carved out specifically an exemption from the Fed in terms of monetary policy decisions. And so, a related but distinct issue is whether or not the cases working their way towards the Supreme Court will engage on the issue of whether or not the Fed's regulatory and supervisory

responsibilities as assigned by Congress are also deserving of that agency independence or if not.

But what's interesting about the initial thinking that was communicated by the Trump folks on this is that they specifically are saying that Fed regulation is subject to White House review. But monetary policy is not. So, it probably sounds a little bit more complicated than you wanted. But that is the current state of play right now.

Allison Nathan: If I'm hearing you correctly when you talk about criticism and rhetoric, that's not all that concerning. But you are more concerned that some of these court cases could actually get traction. Ultimately, what would that mean for the Fed?

Richard Clarida: A scenario that would end Fed independence is pretty straightforward. The existing state of play of this is both in statute and in Supreme Court precedent. A president cannot fire a Fed chair, nor can he fire the head of the Securities and Exchange Commission or the National Labor Relations Board for that matter. And one scenario that would end Fed independence is if the Supreme Court were to say the 1935 Humphrey's Executor

case was not consistent with the Constitution, it is thus overturned. And any independent agency created by Congress that has for cause protection for removal, that protection is no longer valid. And an executive for any reason can remove any independent agency official. So, that would end Fed independence.

What the constitutional lawyers I talk to think could happen is that the Humphrey's Executor 1935 precedent could be narrowed to essentially only provide for cause removal protection to the Fed, but would eliminate it for other agencies.

Now, it's important for me to comment that in other countries there are central banks that by all intents and purposes act as though they are independent, but they, but they do not have that particular protection they essentially have established independence because of a public agreement between the Finance Ministry and the Central Bank. And so I want to be clear that although it would be consequential if Fed independence were eliminated via this judicial path, it would be, at least in theory, possible for the Fed to overtime obtain independence, but it would have to evolve in a different way.

However, if the Supreme Court case went the wrong way, it would at minimum introduce enormous uncertainty into financial markets and it would lead to probably expectations of higher inflation. And the way assets are priced and valued and the way capital flows is all intimately related to an assumption of investors that in most or now really all advanced economies that central banks are reasonably independent, and that price stability and a low and stable rate of inflation is a reasonable long-term forecast. International financial markets will look a lot different if the long run rate of inflation in every country is subject to the whims of whoever is elected. So it would be very consequential for sure.

Allison Nathan: Interesting. Okay. Let's move on from the court case and just talk about the fact that, of course, Chair Powell's term is up in a year and there's a lot of speculation about who takes that spot. If someone who is viewed as more aligned with the administration is appointed, what would that look like? And how concerned should we be about independence in that scenario?

Richard Clarida: Monetary policy is actually not set by the

chair as an autocrat. It's actually set by a committee created by Congress. The Federal Open Market Committee, as we know it today, was created by Congress in 1935. And the statute says that decisions on what we now call monetary policy are made by the Federal Open Market Committee, which is comprised of the seven Senate confirmed and presidentially nominated governors. And then five of the 12 reserve bank presidents, with the New York Fed having a permanent seat on the Federal Open Market Committee.

And thus, to raise rates or lower rates, you need to have seven of the 12 folks vote to raise rates or a vote to sell treasuries. The chair only has one vote. Now, by tradition and by practice, Fed chairs are very influential. And I can't think of a circumstance in recorded history where a Fed chair was outvoted on a monetary policy decision.

But in the scenario that you lay out, if a new chair comes in which has a policy that is demonstrably inconsistent with the mandate of price stability and maximum employment, then he or she would only have one vote and could be out voted by the FOMC. And so, that's an important check on bad policy.

And also, whoever is nominated by the Trump White House will be subject to Senate confirmation. And Senate confirmation for Fed chairs is not a rubber stamp, senators of both parties take Fed nominations, Fed chair in particular, very seriously. And so, whoever gets through the gauntlet of a Senate confirmation from Fed chair is going to be someone who I think coming in will have a longstanding career and broad recognition of what sort of a chair he or she would be. And I think will be someone who a majority of the senators and probably well more than a minimal majority of senators think will be capable of respecting the Fed's independence.

And I'm sure that question will come up. It actually even came up during my confirmation hearing as well.

The other check on the system is, you know, once you're in the job and you do even a little bit of armchair history reading, what you realize is that Fed chairs and central bank governors more broadly in the history books are judged first and foremost by did they achieve or maintain price stability? Obviously, there can be difficult circumstances like the pandemic or the global financial

crisis. But once you get in that job, you're cognizant at least to some extent that the history books will not be kind to you if you screw up the 40-year legacy of price stability that we can trace all the way back to Paul Volcker and then Alan Greenspan.

Allison Nathan: Rich, I have to say, you sound less concerned about the independence topic than maybe I thought you would. Is that the right interpretation?

Richard Clarida: Well, put it this way, relative to my time when I was vice chair, when I thought that the odds that the Supreme Court could actually overturn the relevant case that would make Fed independence null and void, which I thought then were essentially zero, they're no longer zero. There is a positive probability. And so, that would concern me.

So, I'm certainly more concerned than I was when I was a Fed vice chair. But it's not a chronic worry for all the reasons that we've gone through in terms of what may happen with the Supreme Court, the checks and balances, the confirmation process, and the committee structure of the FOMC.

Allison Nathan: Cochrane agrees that the Fed's day to day independence is important. But he says that the Fed should bend to political pressure every now and then because it's accountable to Congress and, ultimately, voters.

Let's say we do have someone who takes the seat and manages to influence the committee to lower rates because that's what the president wants. Ultimately, what does that look like?

John Cochrane: Well, get out your bell bottom jeans and your wide ties because it's going to look like the 1970s. Already, even without Trump, the Fed is going to face real troubles. Suppose inflation gets going and the Fed this time isn't going to sit on its hands for a whole year and do nothing while inflation surges. So, suppose the Fed has to fight a substantial inflation. Without Trump, what do we got ahead of the Fed?

First of all, we've got 100 percent debt to GDP ratio. So, every time the Fed raises interest rates 1 percentage point, that's 1 percent of GDP interest costs on the deficit. So, to

the extent that out-of-control deficits are fueling inflation, you just poured gas on the fire. Second, if it tries to raise interest rates, you know, hello Silicon Valley Bank. My sense is throughout the financial system, there are lots and lots of people borrowing short and lending long. And exposed to interest rate risk. And hoping the Fed will come bail them out again when trouble comes. So, the Fed, if it's not thinking, whoa, if we raise rates are we in trouble? They're in trouble there.

Suppose we replay 1979 and the tariffs cause a big recession. And inflation. And the Fed says we need to raise rates, like they did in 1980 and '82 to combat the inflation. That's going to cause a huge recession. The government responds to recessions with bailouts and stimulus. It's going to pour more fiscal juice on the fire. It's going to be even harder than '80 to '82 to contain the inflation. And think of the political fallout at the Fed when there's already people out of jobs, factories closing. You know, everybody who needed to import anything from China is out of business. And that's before Trump's appointee gets going.

So, Trump's appointee needs to be someone who can say no when it's the time to say no. But the Fed does need to

bend a little bit to political pressure every now and then. It is a creature of our government. Accountable to Congress. And if the Fed wanders off into things the Fed has no business doing, and that the people who vote in Congress and the president are unhappy with, it needs to change to that political pressure.

Allison Nathan: In fact, Cochrane thinks the Fed has become too independent in some ways.

John Cochrane: The Fed has also wandered into areas that are beyond the traditional Overnight Fed Funds Rate Inflation or Employment. It bought a ton of mortgage-backed securities to lower mortgage rates. You know? Subsidizing housing versus something else, that's a pretty political decision.

The Fed steered the political waters and kind of dipped its toes into climate risks to the financial system. It started doing a lot of work on inequality. So, you can see why people who don't like those decisions are a little mad at the Fed and saying, well, we've got to rein in the Fed. It's not in principle terrible to the political system to say the Fed is a little out of control, we need to bring it back. It's the

political system that created the Fed, after all.

So, one of the first jobs of the next Fed chair should be an internal reform and recalibration to kind of get back to what is our mandate, what do we do, and what do we not do? And that should extend not just to monetary policy making, but to how we handle financial regulation. Where I think the Fed has overreached a lot. That has to be done very wisely.

But yeah, rethinking what does this institution do and a bunch of you guys are doing things that we shouldn't be doing is I think an excellent program.

Allison Nathan: Richard Clarida, however, sees it differently. Some people make the argument that Fed independence has kind of gone awry.

Richard Clarida: Yeah, I've heard that.

Allison Nathan: Wading into too many areas not consistent with the initial relatively limited remit. What's your response to that? Has the Fed gotten too independent in a sense?

Richard Clarida: Well, I think here the particular details are important. And so, some Fed critics point to Fed communication or efforts involving the climate or the green transition. And I'm certainly in the camp, and I was as vice chair, that that is nowhere in the statute. It says maximum employment, price stability.

And so, I think whatever engagement that we would see from the Fed in that domain, I think, would have to be very limited. You know, during my time, the primary focus on things related to climate was simply in the Fed's supervisory capacity. If you had financial institutions with a lot of exposure to climate risk, that should be reflected in the way that they were supervised. And so, I think certainly there's a case along that narrow dimension.

Other critics have talked about quantitative easing. So, the Fed ballooned its balance sheet in the global financial crisis through three rounds of QE and then during my time we did QE4, initially during the pandemic and then extended it into 2021. And I think there are legitimate discussions to be had about the cost and benefits of QE going forward. And also, historical assessments of the benefits and cost of

QE.

But I don't think the act of the Fed buying a treasury or a Fannie or Freddie mortgage-backed security, in and of itself, represents mission creep or harm to its mandate. It's really more about the fact that QE has become an enduring part of the Fed's footprint in the financial system.

So, one could imagine the Fed doing QE1 in '09 and then reversing it and doing QT and reversing. I mean, what has happened is that the QE programs have ratcheted up the footprint of the Fed in the treasury and in the mortgage-backed securities market. And so, I would distinguish between decisions to keep existing QE programs and keep the balance sheet large from decisions to use that tool in a downturn.

And then thirdly, some folks have criticized the Fed in terms of decisions it makes in terms of supervision of regulation as impinging on its independence. And here I think one needs to be careful. When the Fed regulates back holding companies or state-chartered members of the Federal Reserve system, that's not mission creep, that's in the statute. The Fed didn't wake up and say, "Oh, we're

going to regulate back holding companies. Or we're going to regulate state-chartered members of the Federal Reserve system." That's what the statute says. So, I wouldn't call that mission creep as might be the case in some of the other examples.

As I mentioned earlier in the conversation, there is a question, which we'll ultimately, I think, get to the Supreme Court about whether or not the Federal Reserve decisions on supervision and regulation are independent of White House review. Because certainly, the decisions of the comptroller of the currency are subject to White House review. And so, I think that is something that will be worked out, again, by the courts probably over the next couple years.

But within the narrow question of when the Fed regulates a bank or a bank holding company, is that mission creep? No, that's in the statute.

Allison Nathan: So, Clarida and Cochrane disagree on some aspects of the Fed's activity today. But my main takeaway from these discussions is that the cases moving through the courts could have serious consequences for

the Fed's independence as we know it. So, I'll be watching them closely.

Let's leave it there for now. My thanks to Richard Clarida and to John Cochrane. And thank you for listening to this episode of Goldman Sachs Exchanges. I'm Allison Nathan.

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