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Fed Independence at Stake in Court Case

CAPITAL ACCOUNT

By Greg Ip

Investors are already fretting about the safety of the dollar and Treasury debt. The Supreme Court might be about to give them even more reason to worry.

The court is about to take up a question that, while not directly about the Federal Reserve, could determine whether President Trump can fire the Fed chair.

There's no indication the justices will give the president that authority. And if they did, Trump wouldn't necessarily sack Jerome Powell, whom he nominated to a term that began in 2018.

But granting the president that power would effectively eviscerate the central bank's independence by making its seven governors, including the chair, at-will appointees of the president, like the Treasury secretary.

Investors would henceforth conclude that monetary policy no longer solely reflects the Fed's judgment about inflation, employment and financial stability, but also the president's priorities.

That could inject dramatically more uncertainty and volatility into financial markets. Recent weeks offer a taste of the potential consequences. Stocks, bonds and the dollar all gyrated as Trump imposed and then partially walked back tariffs. And as tariffs drove up expectations of inflation, Trump called on the "slowmoving" Fed to cut rates.

Fed governors are nominated by the president and confirmed by the Senate to 14-year terms, with one serving a concurrent fouryear term as chair. The Federal Reserve Act says they can only be fired for cause. Scholars believe the Supreme Court entrenched that principle in 1935, when it barred Franklin Roosevelt from firing members of the Federal Trade Commission for purely political reasons because they served a quasijudicial role.

But in February, the Trump administration said the court should overturn that precedent, dubbed Humphrey's Executor, for intruding on the president's control over the executive branch. Trump then forced the matter by firing a Democratic member of the National Labor Relations Board and a Democratic member of the Merit Systems Protection Board.

Both sued, arguing the firings were illegal. Chief Justice John Roberts has let the firings stand while the court considers the dispute. He asked both sides to submit briefs by the end of Tuesday.

The justices might first rule only on whether the plaintiffs should get their jobs back, and settle the merits of the case later. The court's conservative majority is known to look skeptically upon Humphrey's Executor.

In a speech Wednesday, Powell said he didn't think the coming decision would apply to the Fed. And there might be ways to contest the dismissal of the Fed chair without the 1935 precedent. Some of Trump's own officials appear wary of a fight. When the White House in February tightened oversight of independent agencies, it included the Fed's bank regulation but exempted its monetary policy.

Some scholars think even if the justices overturn Humphrey's Executor, they will find a way to protect the Fed.

If they don't, they would make the central bank a fundamentally different institution.

Elected leaders are biased in favor of strong growth and low interest rates at the expense of inflation. Studies find that inflation is lower when central banks are independent.

Independent central banks do make mistakes, as the Fed did in thinking inflation in 2021 would be transitory. And they aren't truly free from political influence: Richard Nixon pressured Chair Arthur Burns to keep rates low in the run-up to his re-election in 1972.

~~And merely~~ changing the status of the chair wouldn't change the mandate of the Fed, which is low inflation and full employment.

Yet monetary policy involves countless judgment calls, and a chair worried about his or her job would be expected to skew those calls to protect it.

When a president applied pressure in private, as Nixon did, he and he Fed chair could maintain the outward appearance of independence. But Trump isn't like other presidents. He rejects the very notion of independence and expects the entire federal apparatus to adhere to his priorities, whether punishing law firms that represent his opponents or deregulating cryptocurrency, a favorite of his base and his family. He makes his preferences public, often by social media.

As such, any opinion Trump expresses would be quickly reflected in market pricing. If he calls for lower rates or a lower dollar, markets would conclude that the Fed will listen. The initial response might be for short-term bond yields to drop and stocks to rally. But investors would also expect higher inflation, which would push long-term bond yields higher.

The Fed could try to suppress bond yields by keeping short-term rates low, or buying bonds (as bond prices rise, yields fall). But it "wouldn't be able to suppress the inflation itself," said the Harvard University economist and former Fed governor Jeremy Stein.

Fed officials go to pains to ground their decisions in objective data such as inflation, unemployment and financial prices so investors can infer how new information will affect monetary policy.

"If the independence of the Fed goes away, that thought process on the part of market participants becomes a lot more complicated because they need to factor in what the political situation demands," said David Wilcox, a former Fed economist affiliated with Bloomberg Economics and the Peterson Institute for International Economics.

This is a treacherous time for the Fed to appear politicized. The Treasury has to issue trillions of dollars in new debt in coming years to finance the deficits in Republicans' coming budget. Investors will balk at buying that debt if they suspect a pliant Fed will let inflation erode its value. Some are already limiting exposure to the U.S., judging by the fall in the dollar and rise in gold prices and bond yields that have accompanied Trump's trade war.

The Supreme Court routinely roils Americans' lives with their decisions. This one could roil the financial system.

