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5 on 45:
On the Fed raising interest rates

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PITA: You're listening to 5 on 45 from the Brookings Podcast Network: analysis and commentary from Brookings experts on today's news regarding the Trump administration.

WESSEL: I'm David Wessel, director of the Hutchins Center on Fiscal and Monetary Policy at Brookings, a job I took three years ago after thirty years at the Wall Street Journal, much of that time covering the Federal Reserve. The Federal Reserve is back in the news again, making some decisions for a change. The Fed is entering a new phase. It's more confident that the economy is finally living up to its hopes and forecasts. Unemployment is down, inflation has moved up – not quite to the Fed's 2% target, but it's headed there. The fraction of Americans who are working or are looking to work has actually started to rise, which is a good sign, particularly since we're an aging society and we know that this labor force participation rate over time is going to fall.

So, the Fed has finally decided to start moving to raise interest rates. The Fed cut interest rates to 0 at the end of 2008, and it kept them there for much longer than anybody expected. It raised rates once by a quarter percentage point in 2015, said it was going to a little more than that, but didn't. It raised rates once in 2016 by a quarter percentage point, said that it was going to do a little more than that, but didn't. But now in 2017, it's raised rates once, and Fed officials' projects suggest that most of them expect that they'll raise rates again at least twice this year by a quarter percent each time. They're much more confident that the economy is nearing the full employment and price stability goals that they've been given by Congress, and you could hear in Janet

Yellen's press conference almost a sense of relief that finally things were getting a little bit back to normal.

Of course, nothing is normal in Washington these days, so the Fed has to anticipate not only what President Trump will actually do, but what he'll say. So, we've seen the Fed looking at the president's proposals to cut spending on some things and increase spending for other things; change the Affordable Care Act; cut taxes, and basically what the Fed is saying is, "if the President does a very stimulative fiscal policy, if he widens the deficit by increasing spending and reducing taxes, we'll have to take that into account. Right now, we are not thinking of that too much in our current policy." But they know in the back of their mind that Trump and Congress are much more likely to increase spending and cut taxes than the opposite.

But the second thing is, they know that as they raise interest rates, inevitable there'll be tension with the White House. Presidents rarely like interest rate increases, and if the economy doesn't grow as fast as President Trump likes and the Fed is raising interest rates, I'm sure that at some point he's going to criticize them. We'll probably read about it on Twitter first. But I think the other things that are changing for the Fed are that they know that, for most of the past several years, the Fed has had an ally in the administration when it came to defending the financial reforms that came as a result of the financial crisis, many of them embodied in the Dodd-Frank act. Hank Paulson, President Bush's Treasury Secretary, and Tim Geithner and Jack Lew, President Obama's Treasury Secretaries, were really shoulder-to-shoulder with the Fed, defending these financial regulations from an assault by big banks and small banks and some conservative economists. That day is over. The Fed is now going to have to defend Dodd-Frank, the post-crisis financial regulations, without an ally in the administration, and that's going to be quite tough.

And then, finally, we have the interesting dynamics of personnel at the Fed. The Federal Reserve Board has seven members. There are two vacancies now; there'll be a third one in April. So President Trump's going to get to appoint three people to the Federal Reserve Board, three out of seven, and then in early 2018 he'll be able to appoint a new Chairman and a new Vice-Chairman because the terms of Janet Yellen and Stan Fischer are expiring. So by this point next year, the Federal Reserve could look very, very different, and that makes a big difference because the Federal Reserve is one of the most important economic centers of power, not only in our country but in the world.

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