# *The* Fed's Independence Jewel Box

*Former Federal Reserve Vice Chair Richard Clarida sat down with* TIE *founder, editor, and publisher David Smick to discuss the Federal Reserve and other global concerns.*

**Smick: Most of our readers say they agree with the basic thrust of U.S. Treasury Secretary Scott Bessent's article in our last issue. He talked about the Federal Reserve's "gain of function" policy. What did you think of the article? Do you agree with his comments about the independence of the Fed? What advice would you give the next Fed chair on how best to manage the central bank's balance sheet and on how best to utilize quantitative easing?**

**Clarida:** Let me begin by saying that Scott Bessent has in less than a year become a remarkably effective and consequential Treasury secretary with a vast portfolio that includes tax legislation and trade policy, debt management, and foreign affairs. Importantly, he has the complete confidence of the markets, especially the Treasury markets which translates, I believe, directly into lower bond yields than would be the case under a different Treasury secretary.

Bessent raises a number of thoughtful concerns in his essay, including concerns about the size and composition of the expansion of the Fed's balance sheet since the global financial crisis. I have said before that the Fed's policy tools—especially QE and forward guidance—are not exempt from the laws of economics. They are almost certainly subject to diminishing returns and incur costs as well as deliver benefits. Looking ahead, I think there is a compelling case as Fed Governor Christopher Waller has suggested for the Fed to shorten the average maturity of its Treasury portfolio. If indeed the Treasury going forward assumes ownership of decisions about the maturity structure of its debt through bill-financed buybacks, the Fed would still have a role to play in providing liquidity to the Treasury market

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during times market stress as it did in the spring of 2020. As for the secretary's views on the importance of Fed independence, he has said many times "… monetary policy is a jewel box that should be walled off to preserve [Fed] independence," and I agree.

**Smick: Do you agree that the Fed's quantitative easing and other crisis-related remedies were continued beyond common sense? Did they exacerbate the problem of income inequality?**

**Clarida:** Fed Chair Jerome Powell himself said in his remarks at the National Association for Business Economics meetings in October that "with the clarity of hindsight, we could have—and perhaps should have—stopped asset purchases sooner" in 2021. I myself have said that the Fed would have been better off had it not tied its hands in December 2020 to continue QE at its pandemic pace until "substantial further progress" had been made towards its mandate goals of maximum employment and price stability.

However, I would not make the same statement about the other temporary liquidity facilities the Fed set up in the dark days of March and April 2020 when twenty-two million people lost their jobs, the unemployment rate skyrocketed to north of 14 percent, and GDP contracted at a 30 percent annual rate. Those facilities served as crucial backstops to credit intermediation in 2020 and were quickly unwound in 2021.

As for income inequality, the Fed's tools are aimed at keeping employment at its maximum level and that certainly for tens of millions of workers narrows inequality. The most common index of income inequality, the Gini income ratio, has been rising in the United States since 1970, and the slope of the trend line looks the same before and after the global financial crisis and the advent of QE. And for what it is worth, the income Gini ratio—computed by the Census Bureau—in 2024 (the most recent available data) is exactly the same as it was in 2017.

**Smick: The Fed took what seemed like a highly unusual step last year of reducing short-term interest rates by 50 basis points less than three months before the presidential election. A lot of people thought this had politicized the Fed. Do you agree? Why, after the Fed cut rates last year, did mortgage rates not come down?**

**Clarida:** The Fed cut the funds rate for the first time in this cycle at the September 2024 FOMC meeting by 50 basis points. The cut was not a surprise, but the magnitude to many people was. The record shows that the Fed has before cut rates in election years, including in September. For example, the Volcker Fed cut rates in September 1984 and Alan Greenspan cut rates in August 1992, and in neither of those episodes was the U.S. economy in recession. The case for a rate cut in 2024 was straightforward: inflation was falling rapidly (six-month core PCE inflation running at 2.4 percent down from 3.4 percent in June) and the unemployment rate was rising sharply (from 3.4 percent in March to 4.2 percent in September), and it made sense to dial back on restrictive monetary policy. As for 50 versus 25 basis points, that was likely a closer call. Treasury yields did rise after that rate cut, and it reflected both higher real rates and higher break-even inflation. That said, the level of break-even inflation after that rate cut—at least at the five-year point—was in the range observed twenty years ago and broadly consistent with anchored inflation expectations.

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**Smick: If you were president of the United States, who would you pick as the next chairman of the Federal Reserve? Beyond yourself, of course.**

**Clarida:** The short list apparently is comprised of Waller, National Economic Council Director Kevin Hassett, and former Fed Governor Kevin Warsh. I know and respect each of them, have worked closely in the past with Governor Waller and Director Hassett, and always have learned from my many conversations and exchanges with Warsh over the years. Any one of them would make an excellent choice as Fed chair.

**Smick: Why does gold continue to soar in price? Are the Chinese buying with the hope of someday establishing a gold-backed reserve currency that they control for the Asian region, as some U.S. Treasury officials suggest?**

**Clarida:** My sense is that a number of foreign central banks and sovereign wealth funds have been increasing their allocations to gold in recent years, but hard data is scarce. I do recall a conversation with a prominent sovereign wealth fund a decade ago. When I asked the CIO why

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his fund was increasing its allocation to gold, he replied, "Gold doesn't default."

**Smick: A lot of dollar bulls argue the greenback has no competitors and will remain the world's reserve currency regardless of our policy position. They point to the Bank for International Settlements data on foreign exchange swaps. It is a market used for dollar hedges and is therefore huge. It is virtually impossible to be duplicated. Do you buy this analysis?**

**Clarida:** Yes, completely. The dollar is not only a "reserve currency," it is truly a dominant currency in trade invoicing and international lending and derivative markets. Treasuries remain the dominant global collateral asset. There is no alternative at least for the rest of this decade.

**Smick: Could stablecoins, collateralized by U.S. Treasuries, play a role in supporting the dollar in the long term?**

**Clarida:** If stablecoins do take off globally, they will very likely be U.S. dollar stablecoins collateralized by Treasuries. To the extent that stablecoin demand is incremental and does not substitute for currency, the potential new demand for Treasury bills is enormous.

**Smick: Is Europe economically in trouble, brought about in part by an innovation slowdown and by Germany giving up its debt "brake"?**

**Clarida:** All advanced economies have aging and slow-growing populations and most have too much government debt. Looking ahead, growth will be driven by productivity gains, not labor force expansion, and the prospects are for U.S. productivity growth to continue to outpace Europe productivity growth in the years ahead. As for Germany, it is one of few advanced economies to have legitimate fiscal space, so depending on how fiscal policy is deployed with the release of the debt brake, it could make a difference for Europe.

**Smick: Is the United States entering another industrial revolution, with major jumps coming in productivity growth? We saw the railroads in the 1890s, the internet in the 1990s, and now artificial intelligence. Note: AI is growing at a pace ten times the pace of the internet revolution. What is your take on the future effects of AI?**

**Clarida:** AI may not yet show up in the productivity data, but it is driving the macro data. An interesting feature of the AI capital expenditure boom is that it is bullish for a lot of "old economy" industries and bricks-and-mortar companies as well as new economy services and chips. In the longer term, AI will show up in the productivity data. The real question initially is whether it will be labor-augmenting or labor-substituting.

**Smick: Are tariffs inflationary?**

**Clarida:** Tariffs put some upward pressure on the price level and we do see that in the data for imported goods subject to tariffs. But the pass-though is not one-for-one—exporters absorb some, as do profit margins of U.S. importers—and there is really no credible evidence so far of "second round" effects of tariffs on expected inflation in the longer term. Moreover, overall inflation as measured by the PCE price index is roughly unchanged since January 2024 at the still-elevated level of 2.7 percent. So whatever upward pressure on inflation there may be from tariffs has been offset by other components of the price index.

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**Smick: What is your economic outlook for the U.S. economy in 2026? Do you buy the notion proposed by some that GDP growth could reach the high-3-percent level? Will tariff inflation catch up to the Trump economy?**

**Clarida:** The baseline outlook for the U.S. economy in 2026 is trend growth below 2 percent, inflation stuck at 2.7 percent, and unemployment rising to 4.5 percent. If the consensus is wrong, it is likely to be wrong on the low side for growth and possibly inflation. The Trump One Big Beautiful Bill Act tax cut will be kicking in, the tech capital expenditure boom may boom louder and longer, foreign companies and countries may starting delivering on their promises to invest in America in exchange for lower tariffs, and the labor market may tighten up, not soften. There are a lot of variables in play.

**Smick: Thank you very much.** ◆