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The President Needs a Lesson on Interest Rates and the Federal Reserve

During one of the President's tirades about the Federal Reserve and Chairman Powell, he made the claim that: "I know a lot about interest rates!" I could only assume that he was referring to his time as a businessman when he knew enough to artificially inflate the value of his assets in order gain a favorable loan rate. This 'knowledge' of how interest rates work earned him a conviction for bank fraud.

However, as a long-time economics professor and former Federal Reserve economist, I'm led to believe, from many of the President's other comments, that he must have slept through—or otherwise skipped class on the days of—the lectures on interest rate determination and the role of the Federal Reserve. (As he must have done during his Econ 101 course regarding the lecture on 'comparative advantage' and the benefits of free trade). Let me enlighten the man on some of what he missed.

The late economist, Irving Fisher, proposed a simple mathematical expression to summarize the essence of what determines market interest rates. It is known as the *Fisher equation*, and it applies (approximately) to any financial asset.

$$i = r + \pi^*$$

The symbol i represents the 'nominal interest rate,' ie., the actual rate of return an investor expects to receive on his investment. In the case of an interpersonal loan, it is the agreed upon interest rate that one observes, for example, when borrowers apply for a loan or investors buy a bond or deposit money in a savings account. In the case of a stock investment (or equity) it is the implied, actual rate of return an investor *expects* to receive in the future.

The two symbols on the right-hand side of the equation are always unobserved at the time that the loan or investment is made, but form the essence of how a financial market arrives at

a value for the nominal interest rate. The second of these terms, the symbol π^*, represents the expected rate of inflation to prevail over the term of the investment. The first term, given by the symbol r, then represents the *real, after-inflation* expected rate of return on the loan or financial asset. Here's a simple example for an interpersonal loan:

> An investor has say \$1000 in cash that he wishes to invest. He considers making a one-year loan in exchange for a financial claim against the individual borrower to be received at a future date. In this example, the future value of that claim is determined by an agreed upon *nominal interest rate, i*, of say, 5% of the amount of the loan, which implies that in one year, the investor, or lender, expects to receive \$1050.
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> Now, what makes the investor believe that 5 percent is enough? There are three fundamental considerations. The first is the expected inflation rate, π^*. If the investor expects the inflation rate to be 2 percent over the next year (which happens to coincide with the Federal Reserve's target for inflation), then the value of the cash he receives when the asset matures is obviously worth less per dollar than it was at the time of the original investment. The *real (after-inflation) interest rate, r* is given by the Fisher equation as
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> $$r = i - \pi^* = 5\% - 2\% = 3\%.$$
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> Then, to determine whether the 5 percent nominal interest rate is sufficient to make the investment, the investor must decide whether a *real rate of return* of 3% is high enough to warrant the investment, and there comes the rub!

What does this simple example tell us? Since the Fisher equation is a close approximation for the determination of nominal interest rates on *all* financial assets, a look at the components is revealing. For an individual investor, the expected inflation, π^*,

would be same for all assets (over a given future time period). However, the real interest rate, r, is specific to each and every asset. What determines its value? Essentially, it's the risk of *not* receiving the expected real return from the investment. That failure to receive the expected real rate could come about from a default or partial default of a borrower, the underperformance of an equity, or higher than expected inflation. The greater is that risk from any source, the higher would be the required expected real rate of interest, r, in order for the investment to be made. *High risk, high expected return.*

It should be noted that the President's on-again-off-again draconian tariffs have impacted nominal interest rates on long-term assets by raising *both* contributors: higher expected inflation, as well as greater uncertainty over future inflation and future economic growth. It's no wonder the Federal Reserve has had to slow its restoration of interest rates to a long-run neutral position, that is neither stimulative nor restrictive of economic activity. And it's no wonder that businesses, both large and small, have had to place their plans for future expansion or modernization on hold.

But in the case of a personal loan, one way the risk to a lender may be mitigated is by collateralizing the loan. The greater the value of the collateral, the less of the initial investment is at risk, and the lower would be the required expected real interest rate, and hence, from the Fisher equation, the lower would be the nominal interest rate on the loan. This is apparently what the President "knew" when he committed bank fraud by overstating the true value of his assets to achieve a more favorable (nominal) interest rate, i, on his loan.

Now, we can turn to the Federal Reserve and monetary policy. The Federal Reserve was created by an Act of Congress and therefore does not have any authority granted to it directly by the US Constitution. Its authority resides solely by that given to it legislatively by Congress, which in turn maintains oversight. The Chair of the Federal Reserve makes semi-annual reports to committees in both the House and the Senate, and responds to

numerous inquiries throughout the year from Congress respecting its twin roles as the nation's monetary authority and as one of the chief regulators of the US financial system, with particular emphasis on the banking sector.

The President has no authority over the Federal Reserve, or over its conduct of monetary policy. In fact, Congress *explicitly* forbade political interference in the determination of the nation's monetary policy, by establishing the Federal Reserve as an independent central bank, with authority to arrive at its policy decisions through the own independent deliberations. These deliberations are informed by the considerable expertise of the Fed's formidable professional staff (including the largest single contingent of PhD economists in the world).

The actual decisions on interest rates are determined by a vote from the twelve-member Federal Open Market Committee (FOMC), which consists of seven Governors (who comprise the Board of Governors) and five of the twelve Federal Reserve District Bank Presidents, who serve as voting members on the FOMC on a rotating basis. The President's ONLY role is in the nomination of the Board members, who must be approved by the Senate. They are appointed to serve a single non-renewable 14-year term. The Chair is one of the seven Board members and has a 4-year term as Chair, that may be renewed during his or her 14-year term. The President therefore has NO say on the policy that the FOMC ultimate decides, nor does he or she, despite being the Chief Executive over the federal bureaucracy, have the right to hire and/or fire employees of the Federal Reserve. Dismissal of a Federal Reserve officer, in particular, can only be done for malfeasance in office while carrying out his or her official duties. This provision of the Federal Reserve Act has been supported by the Supreme Court in an earlier Court decision that gave the Federal Reserve special status among federal employees exempt from executive control. They cannot be treated by the President as the 'political spoils' of an election.

Why was Congress so explicit about insulating the Federal Reserve from the Executive Branch of government, and giving it the statutory independence to conduct policy as it deemed best

for achieving its Congressional mandate of 'price stability' and 'maximum sustainable employment'? The reason is to prevent what the current President wishes the Federal Reserve to do. The US government is running unsustainably ls large federal deficits, which have become worse under the 2025 budget bill passed by the current Congress. The President has stated the Federal Reserve "should do the right thing" and lower interest rates to reduce the burden on the government's budget, where interest on the debt is the second-largest expenditures item.

How would the Federal Reserve accomplish that? They would conduct so-called 'open market operations' by which they would buy up the government debt that the Treasury Department has issued to cover the government's shortfall of tax revenues needed to meet its expenditures. While the details are a bit more complicated that this, in the process of buying up this debt, the Federal Reserve would effectively pay for it by increasing reserves in the banking system, thereby increasing the supply of loanable funds, and thereby lower interest rates—including the interest rates on government debt—thus stimulating economic activity in the short run.

Of course, there's another greater price to pay in the long run when this policy is pursued too aggressively: *Higher inflation.* Now, go back to the Fisher equation. What does this higher inflation imply about nominal interest rates in the long run? It is this reason why economists warn against the extreme interest rate policy that the current President is attempting to push the Fed toward enacting! It would ultimately mean *higher* interest rates and *slower* economic growth, with *higher* unemployment. Neither of the Federal Reserve's twin objectives in their Congressional mandate (stable prices and maximum sustainable employment) would be met.

History has provided amble precedent for these bad outcomes from governments so structured that monetary policy was under the direction of the Executive branch of government. In the high-inflation era of the 1970s, lax monetary policy created worldwide inflation. As a result, democratic governments around the world—including Japan, New Zealand, Australia,

Sweden, the UK, and later the European Union—enacted central bank reforms that effectively granted the monetary authorities independence to conduct policy as they saw fit in order to achieve mandated goals, usually of the form of an inflation target in the range of one to three percent.

The President seems to want history to repeat itself in the United States, when the stagflation that beset the world brought inflation rates to double-digits, eventually leading to the most severe recession in the 1980s that the economy had experienced since the Great Depression. Unemployment topped 10 percent, higher even than during the Great Recession of 2008-9. I suppose the President is counting on that long-run debacle occurring after he leaves office. In the meantime, he pushes for lower interest rates to put America on a sugar high.

So what else does the President "know" about interest rates? More myopic manipulation, it seems. With his approval rating in the toilet (falling below 40% approval, and bumping up against 60% disapproval), the President is making hail Mary pronouncements to buy votes. After attempting to divert attention away from his domestic troubles with military intervention abroad seeking a 'patriotic boost' (See the *Commentary: The MAGA President's Anti-Nation-Building Nation-Building.*), he suggested writing checks and sending money directly to voters (which happened once before with the George W Bush Administration, albeit at a time when the US was running large—and it's last—budget surplus as opposed to the record deficits this President has helped to amass). Now, along with his pressure on the Federal Reserve to lower interest rates, he wants to manipulate market interest rates by capping credit card rates at 10 percent (when the average rate is just under 20%). This policy (which is nearly identical, but more extreme than one offered by Bernie Sanders and Elizabeth Warren) would essentially impose price controls on credit. Economists know that price controls almost never work (with the possible exception of damping down 'price gouging' after a national disaster, such a hurricane). They only serve to restrict supply.

As the discussion above suggests, credit card debt is unsecured. Lenders therefore must expect to receive a sufficiently high interest rate to extend this type of credit. As a result, capping the rate at 10% would likely reduce the availability of credit substantially. Lines of credit would be slashed, terms of repayment tightened, and credit card privileges entirely withdrawn for many current credit card holders. According to a study by the American Banker's Association (ABA), a cap of 15% would adversely affect the availability of credit for 90% of those consumers who rely on credit card debt for short-term liquidity needs arising from medical bills, needed home repairs, etc. Admittedly, the ABA has a strong self-interest in opposing these "price controls" on consumer credit. Nonetheless, their estimates, even if somewhat exaggerated, are so large that an even lower cap of 10% would be draconian indeed!

It's not clear how such a policy that the President is proposing would be implemented. Presumably, it would require regulatory changes that may need Congressional approval. Whatever the mechanism, it's hard to see how it could have anything but a very short run positive affect on economic activity in the event that existing debt were forced to conform to the new cap, whereby the lenders would have to absorb the losses. In the long run, apart from the financial instability that would likely ensue, the policy would clearly restrict access for consumers to unsecured lines of credit, and that cannot be good for the economy. It would seem that the ECON 101 lecture on the consequences of price controls was another one that the President failed to attend, or chose to take nap during its presentation.