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Brenton Swenson
brenton.swenson@gmail.com

Sven Wilson
sven_wilson@byu.edu

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Just How Independent is the Fed?

Brenton Swenson, Masters of Public Policy
Faculty Mentor: Sven Wilson

Introduction

• The Federal Reserve has a dual mandate to fight inflation while keeping unemployment low.
• The Fed is designed to be largely independent from political influence. Just how independent the Fed actually is remains an open question.
• According to Political Business Cycle Theory, presidents who want to maximize their chances for re-election will attempt to fight inflation early in their term, while allowing inflation to rise before the election with the goal of boosting the economy. 

Data

• Monthly data on the Fed Funds Rate, the unemployment rate, and the CPI from 1955 to 2005 was obtained using the dataset used by Todd E. Clark and Richard W. McCracken in their article “Averaging Forecasts from VARs with Uncertain Instabilities,” published in Journal of Applied Econometrics, Vol 25, No. 1, 2010.
• I constructed variables for inflation from the change in CPI and dummy variables for every 4th year (election year, year prior, etc).

Hypothesis

• The Fed will raise the Fed Funds Rate in response to inflation more in the first 2 years of a presidential term than in the latter 2 years.
• This pattern will be visible for presidents who were re-elected, or when the same party retained the presidency, but not when the party lost the presidency.

Methods

• I ran time-series regressions with the Fed Funds Rate as the dependent variable. The main independent variables were unemployment and interaction variables between inflation and a dummy variable for political year type (election year, year prior, etc.)
• To control for serial correlation and heteroskedasticity, I used robust standard errors.
• To control for reverse causality, I included the FFR lagged one month.

Discussion

• When the same party retains the presidency, whether through re-election or in an open-race, there is evidence that inflation is managed as Political Business Cycle Theory would predict.
• There is no evidence inflation is managed in this manner when the same party does not retain the presidency.
• Dramatic differences in how the Fed changes the FFR in response to inflation across different political years gives evidence that the Fed may be susceptible to presidential pressure. Why some presidents appear more able to influence the Fed than others remains a question for further study.

References