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Fed Thoughts: William McChesney Martin's Pertinent Advice for Our Times

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The Federal Reserve's (Fed's) inflation strategy has been characterized by patience, hoping that supply chains continue to heal, expecting slow-moving prices to correct lingering relative price misalignments and maintaining a balanced labor market to prevent cost pressures from emerging. **We believe this strategy implies that occasional modest realignment in the nominal fed funds rate will be appropriate from its restrictive level.**

That the expected adjustments are modest and depend on the demonstrated persistence of lower inflation likely gives the Fed scope on the timing. The key tell about the Fed's intent on the timing is its characterization of the current real rate relative to the neutral real funds rate, or the level consistent with resources in balance and demand growth at trend.

Real Federal Funds Rate

Lower bound of the nominal target range less twelve-month change in PCE price index, percent

Source: Bureau of Economic Analysis (personal consumption expenditures price index) and Federal Reserve (lower bound of the range for the nominal fed funds rate), accessed via FRED, 2/23/25, and firm analysis. In calculating the real rate, Personal Consumption Expenditures (PCE) inflation for the past two months is assumed to hold at 2.5%.

In the press conference following the November 7, 2024, meeting, Fed Chair Powell echoed the sentiment in the statement that, "we think that even with today's cut, policy is still restrictive."[1] This showed that he was leaning over the board for the next dive, which was another quarter-point cut at the December meeting. After that meeting, the Fed was less assertive in its characterization of the real rate relative to its neutral level. By the time of his February appearances on Capitol Hill for the semi-annual report on monetary policy, this became explicit: "With our policy stance now significantly less restrictive than it had been and the economy remaining strong, we do not need to be in a hurry to adjust our policy stance."[2] This suggests that, **while the Fed is leaning towards a lower policy rate and momentum may carry them forward, action is tabled for later in the year.**

Market participants got the message, as evident in the slamming to near certainty of the probability in futures markets that the funds rate range will likely stay at 4.25 to 4.5% at the conclusion of the Federal Open Market Committee (FOMC) meeting of March 18 to 19. **We think that's right about the headline outcome**, in part because it fits the Fed's strategy but also works to Chair Powell's advantage by keeping his institution out of the headlines in the early days of the new presidential term.

Market Probability of an Unchanged Fed Funds Rate

At the March 18-19 FOMC meeting inferred from futures prices, percent

Source: CME FedWatch tool, accessed 2/23/25.

The problem for the Fed is its transparency about its policy outlook, which has become central to its efforts in shaping market expectations.[3] We believe this transparency puts the Fed in a bind, as policy guidance depends on an assessment of the political economy. The new administration's policies, if implemented, will likely push up prices, requiring an adjustment of the policy path. For example, tariffs would likely directly raise the prices of imported goods. A more aggressive border policy would likely reduce the flow of new labor. Extending the existing tax structure prolongs fiscal support of aggregate demand. But this determination is difficult to make and voice at the start of a presidential term. The Fed would appear judgmental if it presumes certain policy actions by the new administration, and some of these early policy options may not come to fruition, especially those requiring Congressional approval.

Up to now, the Fed has been unspecific about its forecast, with staff putting in "preliminary placeholder assumptions about potential policy changes"[4] and policymakers admitting the direction but not the possible scale of the effects. Their wont has been to look back and ascribe a less rosy inflation outlook to the data rather than look forward and blame planned changes in trade, immigration, and tax policies.

The Fed release schedule sets the hill on which this obfuscation dies, which we believe would not be Powell's choice if it were in his control. **At the March meeting, the FOMC will likely update its quarterly Summary of Economic Projections (SEP), the survey of the views of all participants about economic outcomes and the appropriate policy rate. We expect the inflation forecast to notch higher and some of the dots plotting the appropriate policy rate to drift up.** We still think the FOMC will lean toward easing in its outlook for this year and next, which is about its durable progress in lowering the inertial part of inflation, but less so than previously.

At the press conference, we expect the chair will assiduously point to past data for the revision and list the limitations of the SEP. Included in his litany will likely be that the submissions are based on individual, uncoordinated and unspecified assumptions about other policies, including trade, immigration and taxes. Moreover, its forecasts are modal, meaning the most likely outcome may not align with the average expected one that is crucial for policy setting. But the SEP is the only place where the Fed conveys policy intent with numbers, and its numbers will make compelling reading.

Attributing inflation risks to trade and fiscal policies and scaling back future easing may trigger displeasure from the Executive Office, but it is important to distinguish between *criticizing* versus *interfering* with the Fed.

Interference includes threats to change the membership of the Board of Governors of the Federal Reserve System (Board) or its legal structure. However, there are no positions on the Board turning over until early 2026, with Adriana Kugler's term as governor ending in January and Jay Powell's term as chair over in May. That said, Board turnover can be more rapid than their fourteen-year terms permit. Michael Barr's is voluntarily, ending his run as vice-chair for supervision this month, and he may not want to linger.

While the current president has talked about firing Board members, the legal hurdle is high. Historically, Capitol Hill has voiced many complaints about the Fed but has always been loath to reopen the Federal Reserve Act, which established the Federal Reserve System as the central bank of the United States in 1913. More generally, threats to forcible turnover or legislative change face the risk of a significant market backlash and Congressional disquiet, which traditionally protects the institution it created. We think that the administration has too many other irons in the fire to pursue a gambit that threatens its economic agenda.

Criticism, however, differs and is woven into the design of the Fed. There are elegant theories explaining why a government makes the central bank independent, mostly revolving around politicians appreciating that their short-run incentives for an overheated economy jeopardize long-run price stability. We'd like to think the process was governed by the better angels of political nature, but we don't. We favor an alternative theory that politicians create an independent central bank so that someone else has the responsibility for the economy's performance.[5] The Fed acts as insulation between the elected and the electorate, and it is so positioned in order to be blamed. If so, criticism is an inherent part of a Fed role and the quid pro quo for its independence.

Interference with the Fed's mission would reverse precedent and potentially create self-inflicted damage to the administration's economic agenda, but criticism is to be expected. And this is not new. The most famous characterization of monetary policy comes from Fed Chair William McChesney Martin in 1955. We're all familiar with the close of that speech, "The Federal Reserve, as one writer put it, after the recent increase in the discount rate, is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up."[6]

We believe the sentence before the famous one is equally relevant today, **"Those who have the task of making such policy don't expect you to applaud."** (ibid.) Chair Martin was providing career advice to central bankers that his current successor should take to heart.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also spent 24 years at the Federal Reserve, holding several roles including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

[1] Transcript of Chair Powell's Press conference, November 7, 2024.
[2] Semiannual Monetary Policy Report to the Congress, February 11, 2025.
[3] Jefferson, Philip N. "Reading between the Lines? Textual Analysis of Central Bank Communications, February 21, 2025".
[4] Minutes of the Federal Open Market Committee, January 28-29.
[5] Dixit, Avinash. *The Making of Economic Policy: A Transaction-Cost Politics Perspective.* Cambridge, MA: MIT Press, 1996.
[6] Address before the New York Group of the Investment Bankers Association of America, October 19, 1955

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