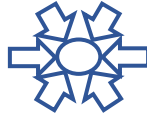


Monetary Policy for Modern Times: The Fed's Missed Opportunity and What to Do Instead



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- There is no doubt that a new Fed chair next year will demand a very different monetary-policy framework, abandoning the modest revisions in 2025 to the Fed's failed 2020 framework.
- The new approach must zealously guard independence but ensure accountability and transparency from a central bank that now sticks to its actual statutory mandate and has the smallest possible footprint on a marketplace that quickly learns to live without the "Greenspan put" and ready supplies of generously-priced emergency liquidity.
- The 2025 framework gives the Fed full discretion to do as it pleases with regard to employment, inflation, and financial-market intervention – a violation of its mandate. The Fed also plans to do as it pleases with trillions in its own portfolio for whatever purpose suits it. Congress should ensure full statutory-mandate compliance and the smallest possible Fed footprint if the central bank cannot quickly reform itself.
- The Fed must change the manner in which it sets and evaluates monetary policy. The fed-funds rate doesn't work and IORB/ONRRP forces the Fed to set policy by direct payments to large financial institutions that distort private markets and heighten economic inequality. The Fed should also set the current neutral rate and assess restrictive or accommodative impact using – but not relying on – this calculation.
- Supervision and regulation should be insulated from independent monetary-policy determinations, with new safeguards to prevent political abuse.
- Payment-system and other tasks unrelated to monetary policy should be separated from the Fed because political unaccountability is inappropriate for these market interventions.

With all the majesty a mountaintop affords, Federal Reserve Board Chair Jerome Powell on August 22 announced the monetary-policy framework that will guide the central bank until 2030.¹ Or, so he said. Unfortunately, the 2025 model is little different than the 2020 model also eagerly awaited by economists and traders around the world.² That model failed miserably in large part because it was so focused on fixing the flaws in its predecessor that it did not contemplate problematic inflation. This followed the 2020 announcement in less than a year, leading to price levels that not only helped to topple a president in

2024,³ but also made the majority of American households still worse off.⁴ Even more troubling, a majority of Americans have now lost faith in the “American dream.”⁵ No wonder – for most Americans, the economy is just a grim reality in which their chances and those of their children fall farther and farther behind.

The Fed’s 2020 failure is its own fault, as is its sizeable contribution to the ever-widening gap between the top one percent of American households and almost everyone else. The top one percent hold 30.8% of wealth in the U.S. compared to the 32.8% held by the bottom ninety percent.⁶ This chasm is not the fault only of the Fed, but the U.S. central bank has a statutory mandate to promote the “general welfare,” and its monetary policy over the past decade has done precisely the opposite.

It’s time for a far more meaningful change than contemplated in the Fed’s 2025 pronouncement. This brief thus examines the 2025 model, finds it more than wanting, and lays out specific policies the central bank can and should adopt that in no way affect its independence. This must be preserved, but independence is no exemption from accountability and transparency. Here, significant corrections are long overdue.

A new Fed model is in fact being developed – indeed, demanded – by Treasury Secretary Bessent.⁷ This brief moves the debate forward with detailed recommendations on matters such as the Fed’s portfolio for consideration by the central bank, Treasury, and Congress. Nothing in it undermines the Fed’s independence, which is, as Secretary Bessent acknowledges, “fundamental to the economic success of the United States.”⁸

Minding the Mandate

Before turning to the 2025 model and offering a replacement, it is important to place reforms in the context of what Congress demands of the U.S. central bank. Regardless of what Mr. Powell, I, or anyone else wants, the law is the law and that is the Fed’s prime directive. As shall be shown, the statutory mandate is far afield from the “dual” one in which the Fed prefers to cloak itself.

The Employment Act of 1946, reinforced by changes to the Federal Reserve Act in 1977,⁹ states that monetary policy is to “achieve the long-run potential to increase productivity...to promote the goals of maximum employment, stable prices, and moderate long-term interest rates.” Current law also stipulates that monetary policy is to “foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment, for those able, willing, and seeking work, and to promote maximum employment, production, and purchasing power.”¹⁰ The law also defines employment as providing “real income.”¹¹

As a result, employment is not “maximum” if a significant percentage of part-time workers want full-time jobs or many workers have left the labor force because they cannot find jobs – both of which are now at four-year highs.¹² The Fed can and should judge employment not only by an aggregate index, but also by what the law rightly calls “real income.” This must be judged not only by inflation-adjusted measures of capital income – i.e., stock-market gains – but also by inflation-adjusted wages at the median – not average – level across the distributional curve. An inflation-adjusted bag of groceries that cost a family \$100 in 2019 now costs \$130, a 30.82 percent increase;¹³ real wages over this period have gone up only 3.9 percent,¹⁴ deepening the divide between the haves and have-nots no matter how close the Fed thinks it has gotten to its inflation target and maximum employment. If tariffs lead to higher food prices as wages

drop and unemployment rises, then the Fed's monetary policy will exacerbate economic hardship and do still more grievous damage to the general welfare.

Further, the Fed must define "price stability" going beyond its preferred inflation gauges to look also at the price levels that determine family economic well-being. Inflation may be controlled if it falls below the Fed's preferred two percent target on its favorite measure, but disregarding "one-time" price hikes – the Fed's current thinking about tariffs¹⁵ – ignores the sharp increase in the cost of living resulting from lasting spikes affecting the sixty percent of Americans already having trouble paying their bills.¹⁶ A slower increase in the rate of inflation does not mean more of the "purchasing power" the law instructs the Fed to preserve and enhance.

The Fed has cherry-picked its mandate not only by deleting one important component – moderate long-term interest rates, but also by adding one found nowhere in its authorizing law: ensuring financial stability. As the 2025 FOMC statement reiterates,¹⁷ the Fed takes its power here by inferring that the only way to ensure the two parts of its mandate it likes – maximum employment and price stability – is also to protect financial stability. There is no question that financial crises wreak macroeconomic havoc – see 2008 – but not every financial tremor is a macroeconomic earthquake. As in 2019 and again in 2023, the Fed more often than not protects financial markets from themselves when it rushes in trillions in financial support. Even in 2020, when the pandemic struck, the Fed's backstops reached far beyond those essential to supporting orderly markets to bailing out even highly-speculative markets such as corporate junk bonds.¹⁸ Because the Fed believes in the "wealth effect," it all too often acts to ensure that those with wealth never lose it no matter the gambles they take. Vice Chair for Supervision Michelle Bowman has argued that the central bank has now "institutionalized" its role as an ever-ready market backstop,¹⁹ noting that this not only undermines market integrity, but also clouds monetary policy in a fog of signals of the Fed's own making, not the markets'.

Why the 2025 Model Is Little Better than the 2020 Model

Measures by which to judge statutory-mandated compliance are critical improvements, but they do not suffice. In 2020, the Fed adopted what proved to be a fatally-flawed monetary-policy framework known as flexible average inflation targeting (FAIT).²⁰ In August of 2025, this was replaced with a new, as-yet-unnamed approach that seeks a more disciplined approach to quickly countering inflation and promoting employment by defining "maximum" employment as the lowest rate of sustainable unemployment possible in concert with price stability – whatever this means.²¹ Although retaining its two-percent longer-term inflation target, the new policy eschews a specific employment goal, noting only that the FOMC will use numerous indicators to assess it without indicating if wages or labor-force participation are among them (as seems unlikely). The Federal Reserve now also largely disavows responsibility for unemployment, saying that – unlike inflation – employment is largely governed by other factors without making clear why, if the Fed is so toothless, we look to it to preserve "maximum employment" and why the central bank still promises to do so. In short, using whatever tools it wants, the FOMC will find an inflation-employment equilibrium it likes and call it a job well done.

The new policy also states that the Fed's primary monetary-policy tool is the federal funds rate even though it has long acknowledged that the rates it sets on interest paid on reserve balances (IORB) and the overnight reverse-repurchase program (ONRRP) are more effective and, indeed, seemingly the only way the Fed now influences short-term rates.²² Reflecting this undue reliance on market intervention, the

president of the Federal Reserve Bank of Dallas, Lorie Logan,²³ recently proposed an alternative rate target. Why this was not given the consideration it deserves in the 2025 plan is not made clear.

Although acknowledging that the fed-funds rate may malfunction, the new model states only that the central bank will use its “full range of tools” to achieve its objectives. This provides no more meaningful guidance than the Fed’s newest pledges to do something good about unemployment. Surmising what the central bank may mean even though it lacks the courage to say so, note that “tools” most importantly include the huge portfolio first established in 2008 via “quantitative easing” (QE) and somewhat reduced of late via “quantitative tightening” (QT).

The Fed’s portfolio persistence is so puzzling that a committee largely comprised of global central bankers chaired by a former Federal Reserve Bank of New York President begged earlier this year that the Fed at the least should explain why it thinks it needs trillions in assets that lure bank funding out of the economy and enable the giant U.S. deficit.²⁴ They thus implored the Fed to explain if its portfolio is for monetary-policy transmission (and if so, to make clear how this works) or needed to stabilize financial markets, as a recent speech by Gov. Waller supporting a \$2.7 trillion portfolio suggested.²⁵

Just because the Fed wants a big portfolio is no reason for it to have a big portfolio. Trillions housed at the Fed funded in large part by bank reserves boost equity prices,²⁶ trillions from the economy with which the market could well do more than simply float the federal deficit at somewhat reduced cost via the “monetization” of fiscal policy afforded by the Fed’s huge holdings of Treasury obligations.

The Federal Reserve now holds \$4.2 trillion in U.S. Treasury obligations²⁷ or 14 percent of the entire global \$29.4 trillion market.²⁸ This huge position sharply reduces the supply available to private and other governmental investors, resulting in as much as a 100 basis point reduction in the cost of 10-year Treasury obligations to taxpayers and similar reductions across the spectrum of Treasury issuance.²⁹ However, as Treasury Secretary Bessent has said, the Fed’s huge portfolio creates “perverse incentives for irresponsibility”³⁰ when it comes to running huge deficits sheltered from market storms.

Although the Federal Reserve requires banks to plan for the worst, it still refuses to do so itself. Issuing a paper finding that scenario analyses are still too uncertain for monetary-policy planning,³¹ the Fed’s 2025 policy does not even suggest it will try to figure this out and build on scenario-analysis tools developed by former FRB Chair Bernanke for the Bank of England.³² Thus, as with the 2020 policy, the Fed will simply make it up as it goes along if anything fails to go according to plan as it surely will.

As noted, the Fed’s current model also confers unlimited authority to protect financial markets. The central bank does have certain express duties here, including those empowering emergency liquidity facilities and demanding tougher rules for the largest banking organizations or systemic nonbanks. Although these powers are enumerated by Congress with an array of controls designed to ensure accountability to the executive branch and Congress, Treasury has all too often failed to question the central bank and Congress’ scrutiny is minimal to nil.

President Trump’s executive order delineating the limits of Fed independence to monetary policy brings financial-stability tasks more clearly under his authority and thus that of the Treasury.³³ Mr. Bessent is clear: he will not approve emergency liquidity unless circumstances are truly dire.³⁴ As a result, the Fed’s financial-stability edicts can no longer be considered the “Greenspan put” that bails out financial markets whenever stress lurks.

An Equitable, Effective, Independent Monetary-Policy Framework

Key planks in a new, improved monetary-policy model include the following:

- **Portfolio Reform:** The Fed must immediately clarify why it needs “ample” reserves and what “ample” means in practice. If the Fed wants trillions in assets to bolster the Treasury market, then the “ample” level must be set in concert with reviewing all the costly rules imposed on banks and the Treasury marketplace and existing backstops to eliminate duplicative standards that, while they may comfort the Fed, extract resources that could be better put to use in the private economy. Its quasi-fiscal role backstopping Treasury obligations and reducing their costs must also be accountable, transparent, and strictly limited. If the Fed instead believes it needs a significant portfolio to conduct monetary policy, then it must still make clear what this entails, how the portfolio interacts with the ONRRP backstop for nonbanks, and why open-market operations no longer suffice.
- **Analytical Improvement:** Monetary policy set without regard to distributional reality is monetary policy that will continue to misjudge the course of the U.S. economy and thus exacerbate economic inequality in concert with heightening the likelihood of high-risk boom-bust scenarios.³⁵ The FOMC must immediately revise the analytics developed by the Board and Reserve Bank as outlined above in compliance with the Fed’s statutory mandate to specify how real income, labor-market participation, purchasing power, and other factors judged on medians, not averages, signal the extent to which the Fed is in fact meeting its triple mandate.
- **Interest Rates:** The Fed must separately and clearly measure its performance to meet the requirement for moderate, long-term rates whenever possible. The Fed’s justification for neglecting this requirement – that it’s enough to ensure maximum employment and price stability – is thoroughly unpersuasive, as evidenced by over a decade after 2010 of rates well below zero when adjusted for inflation even as the Fed earnestly assured Congress and the public that it was meeting its mandate thanks to employment growth after the great financial crisis and price stability. In fact, real income, labor participation, and purchasing power suffered mightily in part because these ultra-low rates encouraged stock-market speculation and capital distribution, not long-term savings and capital formation. This policy also exacerbated financial-stability risk when Covid struck because neither companies nor households were able to absorb stress and uncertainty.
- **Transparency:** The Fed frequently asserts that it adheres to its preferred version of the statutory mandate, but it fails to demonstrate this to the public to whom it is ultimately accountable. The Fed should not only improve the measures by which it is judged, but also the methodology that defines its purpose. For example, recent dissenting FOMC votes have cited the value of the “neutral” or “natural” rate as a judge of Fed impact,³⁶ as has Secretary Bessent.³⁷ The Fed should decide on the appropriate model for judging the rate at which policy is neither accommodative nor restrictive, running its preferred rate by this measure to clarify monetary-policy intent and effect. The “neutral rate” is hard to measure and somewhat subjective, but the Federal Reserve System has one of the most authoritative models for doing so.³⁸ It should put it to use.
- **Scenario Analyses:** The Fed should regularly stress test its current monetary-policy stance on stress scenarios, incorporating severely-adverse phenomena such as a spike in the rate of inflation of over two percentage points in three months, deflation of over one percentage point in one month, a two percentage point increase in the unemployment rate over three months, sudden short-term market short-term rate reductions that come within one percentage point of the “effective lower bound” (i.e., real rates of less than zero), and nine-quarter stress scenarios incorporating other inflation, deflation, employment, Treasury-rate, and financial-market scenarios. Those by which monetary policy is judged should be published for public comment prior to adoption and revised at least once a year. The

scenarios the Fed determines necessary under severely-adverse scenarios need not be disclosed, as doing so might unduly signal markets and actually precipitate a crisis averted by well-prepared monetary policy.

- **Forward Guidance:** The Fed counts on frequent communications from the Board of Governors and Reserve Bank officials to signal markets as to the direction of monetary policy and thus accelerate its impact. However, forward guidance on near-term policy decisions only works to achieve the Fed's mandate if the underlying policy works. The sharp disconnect between Fed guidance, including that provided in each FOMC report, and the actual economy means that the Fed should sharply reduce its reliance on forward guidance. The extent to which markets hang on every word from almost anyone at the Fed distorts markets, further undermining their ability to set prices based on actual macroeconomic conditions and increasing the odds of sudden, high-risk surprises.
- **Financial-Market Intervention:** The Federal Reserve should publish a clear, specific definition of financial stability as mandated in the 2010 Dodd-Frank Act that is yet to be released.³⁹ Treasury should also take a firm hand in constraining emergency-liquidity support for all but the most unusual and exigent circumstances as required by law.⁴⁰ Further, Congress should expressly limit Federal Reserve backstops only to the discount window and any others established in law.

Conclusion

Although the 1913 law establishing the U.S. central bank has worn well, it is nonetheless worn out in several key respects. These monetary-policy recommendations are substantive and sweeping, but they still aren't enough.

First, Congress can and should consider the location, structure, and purpose of the twelve Federal Reserve Banks to place them in current population centers, not those selected in 1913. Further, all functions of the Reserve Banks not directly linked to monetary policy (e.g., payments, bank supervision) should be brought under the executive branch, with the presidents of each Reserve Bank nominated by the President and confirmed by the Senate for rolling five-year terms to avoid the sort of sudden and wholly political realignment possible in March of this year.⁴¹

Congress should also revisit the "private-sector adjustment sector" by which the Fed consistently underprices private payment services to prevent the central bank from continuing to inhibit payment-system innovation, ensuring also that FedWire is open seven days a week and 24 hours a day to limit reliance on central bank intraday liquidity support. The Fed issued a proposal to do nearly that in 2024,⁴² but has taken no action on this or, for that matter, on the obvious flaws in the discount window that exacerbated the 2023 crises. Again, there is a 2024 Proposal, but no word of any substantive change.⁴³

Executive-branch control of bank regulation and supervision ensures accountability, but may also lead to conflicts of interest or even self-interest that maximize officeholder objectives, not shared prosperity and financial stability. Congress should stipulate that Executive-branch control extends only to supervisory policy, barring senior officials from accessing any personally-identifiable information and that related to specific entities or nations.

Further, the Fed's supervisory rule over banks and any systemic nonbanks should either be removed to other agencies or carefully segregated by a new governance structure within the central bank that transmits information over a monetary-policy firewall only with regard to potential sources of financial-stability risk of macroeconomic consequence that may require deployment of emergency liquidity

support. The vice chair for supervision should remain on the FOMC to ensure that financial stability does not become even more relegated to junior staff with no ability to get the attention of senior officials until a crisis is imminent and most likely irreversible.

And, finally, to the independence of the U.S. central bank. In its 1913 incarnation, the U.S. central bank was authorized only to do central banking. Its independence served it well, especially after this was reinforced in 1935. It should be honored now and, if necessary, reinforced by the Supreme Court or Congress. However, as noted above, the Federal Reserve System has other functions that are far afield from setting monetary policy in which it has direct or (as in payments) indirect coercive power over private financial markets, institutions, and even individuals. It can and should be accountable to public officials to ensure the central bank does the public good in all of these duties, including the allocation of balance-sheet assets if these are deployed for fiscal or market-stabilizing purposes, not strictly for transmitting monetary policy.

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