

The background of the cover is a photograph of the United States Capitol building at night. The building is illuminated with warm yellow lights, and its reflection is visible in the wet pavement in the foreground. Overlaid on the top half of the image is a faint, semi-transparent financial chart with a grid and a line graph. A specific data point on the chart is labeled "78.60%".

Sound Financial Policy

**Principled Recommendations
For the 119th Congress**

CATO
INSTITUTE

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Section 5: Monetary Policy That Holds the Fed Accountable

Congress created the Federal Reserve (Fed) in 1913 to put an end to financial crises and severe recessions. But some of the nation's worst economic crises have occurred since then, and recessions haven't become shorter or less frequent. The US economy suffered its most severe bout of deflation during the early 1930s. It endured its highest peacetime inflation rates in the late 1970s and early 1980s, as well as abnormally high peacetime inflation rates following the COVID-19 pandemic. Despite the Fed's failures, Congress has tended to further expand its discretionary powers.

So long as Congress is inclined to delegate responsibility for conducting monetary policy to the Fed, there is much it can and should do to improve the Fed's performance. For instance, Congress can narrow and clarify the Fed's legislative mandate and require that the Fed implement rules-based monetary policy. It can also remove the current privileged position that the US dollar holds in competition with other potential means of payment so that the Fed faces competitive pressure to preserve, and perhaps enhance, the dollar's attractiveness as both a domestic and an international exchange medium.

THE PROBLEM

One of the Fed's main responsibilities is to ensure that the economy does not stall because of an insufficient supply of money. Its other main duty is to safeguard against excessive money creation, which increases inflation. To conduct monetary policy responsibly, the Fed should also avoid favoring specific firms, industries, or sectors of the economy over others. If it were to conduct policy in this manner, the Fed would place only the smallest possible footprint on economic activity, avoiding as much as possible any tendency to influence the profits and losses of specific enterprises, to favor government over private investment, to create moral hazard problems, or to transfer financial risks to taxpayers.

Finally, the Fed should conduct monetary policy in a

transparent manner, with real accountability to citizens through their elected representatives. Throughout much of its history, the Fed has failed to meet these requirements, and Congress has failed by not compelling it to meet them. In fact, every Fed regime since the 1980s has acted in an increasingly discretionary manner compared to its predecessor. This discretion has worsened significantly since the 2008 financial crisis. Consequently, monetary policy during this period has been divorced almost entirely from clear and understandable rules-based governance.¹

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The so-called dual mandate calls for the Fed to achieve both price stability and maximum employment. Now that the Fed has also become responsible for guarding against financial instability, it really operates under an even broader mandate.² Because the Fed's mandates are so ill-defined, the Fed enjoys enormous discretion in interpreting and performing its duties, and Congress often lacks any means for holding the Fed accountable for fulfilling its responsibilities. Furthermore, because both the behavior of the price level and the extent of employment depend not only on the Fed's decisions but also on factors beyond its control, it is unreasonable to blame the Fed for every instance in which these factors vary from some ideal. As the increased inflation after the COVID-19 pandemic demonstrates, for instance, fiscal expenditures can play a significant role, along with the Fed's monetary policy decisions.

More narrowly, the Fed's price stability mandate is problematic because changes in the price level can also reflect

changes in the scarcity of real goods and services. In other words, changes in the price level or in unemployment may not be evidence of good or bad Fed performance. In an economy experiencing long-run productivity growth, for instance, a low (and perhaps even negative) rate of inflation reflects rapidly falling costs and makes it easier for everyone to reap the benefits of those falling costs. In the short run, adverse supply shocks—such as those caused by a war or the COVID-19 pandemic and related government shutdowns—cause prices to rise even when the demand for goods is not growing rapidly. In fact, research by the Cato Institute’s Center for Monetary and Financial Alternatives shows that such supply factors overwhelmingly drive inflation in some cases. Across various time periods and a variety of inflation metrics, supply factors account for more than 80 percent of aggregate price changes. Monetary policy usually plays a minor role—accounting for only 5 to 10 percent of US inflation.³

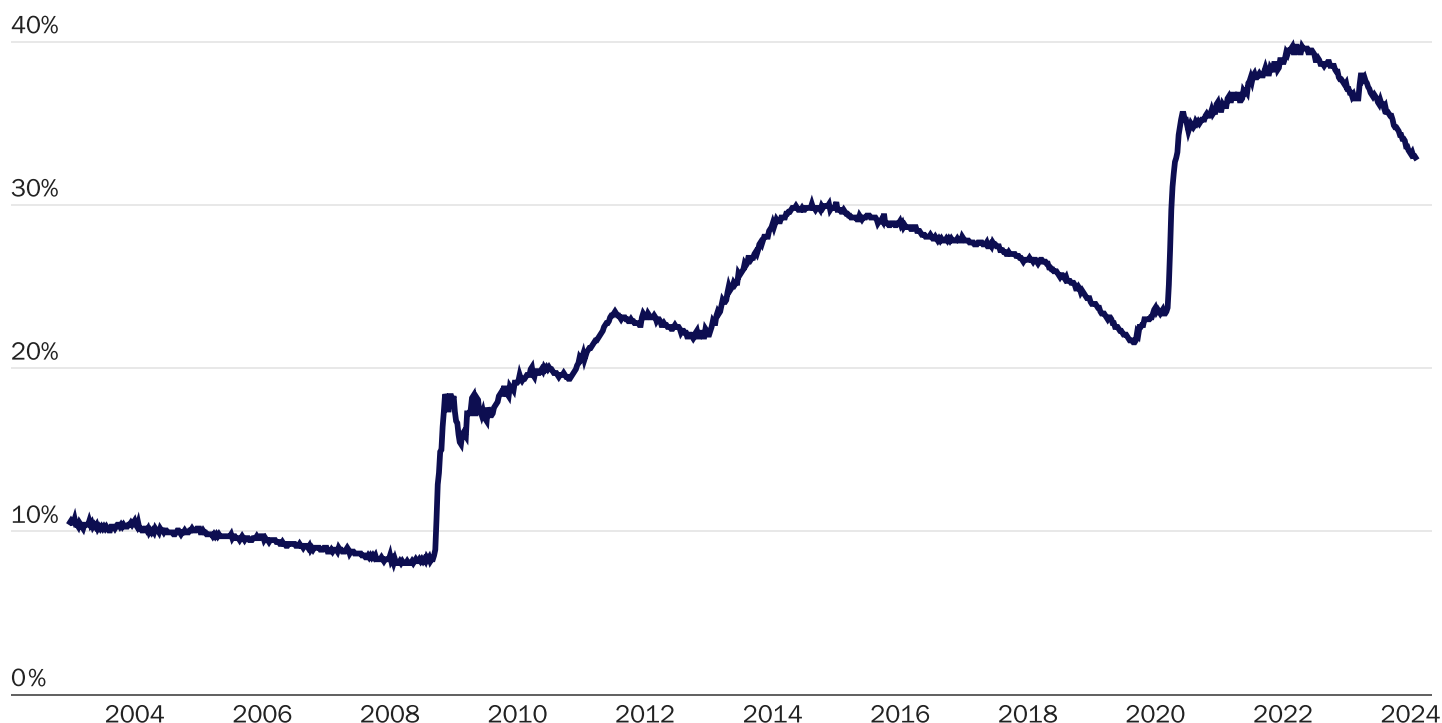
Separately, the excessive amount of discretion that Congress has bestowed on the Fed has allowed it to alter its operating

framework in a manner that has seen its balance sheet grow to roughly 10 times its pre-2008 size. The Fed is now so large that its assets are greater than 30 percent the size of the entire US commercial banking sector (see Figure 7). Prior to 2008, the Fed’s balance sheet was barely 10 percent of the size of the US banking sector, and it had been shrinking in proportion over time. This shift in framework has had serious repercussions for financial markets. Before the 2008 financial crisis, increases in the Fed’s balance sheet led to minor *reductions* in market volatility; after the crisis, balance sheet increases are accompanied by large *increases* in market volatility. Research from the Center for Monetary and Financial Alternatives shows that since 2008, a 1 percent increase in assets may cause up to a 6 percent increase in financial market volatility.⁴

The Fed’s new operating framework, known as a “floor” system, has provided banks with a new risk-free investment choice at a relatively high rate of return, thus causing banks to hold more funds as reserves. As interest rates rise, the Fed will have to pay larger and larger interest payments to banks

Figure 7

Federal Reserve’s balance sheet is larger than 30 percent of the entire US commercial banking sector



Sources: “Assets: Total Assets: Total Assets: Wednesday Level,” Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis, 2024; and “Total Assets, All Commercial Banks,” Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis, 2024.

to control inflation, an arrangement that increases the Fed's political risk and threatens its operational independence.

The new floor system also divorces the Fed's monetary policy stance from the size of the Fed's balance sheet by allowing it to purchase as many assets as it would like, all while paying firms to hold on to the excess cash that these purchases create. This framework can all too easily allow the Fed to be a pawn of the Treasury Department. Put differently, the Fed's current operating system increases the risk that the Fed's quantitative easing (QE) powers will be abused for nonmacroeconomic purposes, such as the funding of back-door government spending.

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Today, thanks to a Standing Repo Facility that the Fed established in 2021, there is no reason why the Fed cannot eventually undo all the post-2008 growth in its balance sheet.⁵ Nor is there anything else to prevent it from returning to a “scarce reserves” operating framework. In such a regime, instead of holding substantial reserve balances, banks would strive to economize on reserves while turning more often to either the private repo market or the Fed's Standing Repo Facility to make up for occasional or temporary reserve shortages. The Fed's QE powers would then be correspondingly limited: Although those powers would remain substantial so long as rates are at the zero lower bound—the only circumstance in which QE may be macroeconomically warranted—it would not otherwise possess them.

A scarce reserves regime, therefore, enjoys the distinct advantage over a floor system of avoiding the risk that the Fed's QE powers will be abused for nonmacroeconomic purposes. To compel the Fed to return to a scarce reserves regime, Congress should insist that the Fed follow the 2006 Financial Services Regulatory Relief Act, a law that stipulates that the

rate of interest the Fed pays on reserve balances should not exceed the general level of short-term interest rates.

SOLUTIONS

The US dollar has long been the preferred payments medium throughout the United States as well as in many international markets. Congress should do all that it can to preserve that high standing by ensuring that the Fed is a good steward of the dollar by narrowing its statutory mandate, requiring it to follow a policy rule, and shrinking its balance sheet.

- **Narrow the Fed's statutory mandate.** Congress should repeal the financial stability mandates that it gave to the Fed in Title I of the Dodd-Frank Act and remove the Fed's responsibilities as a financial regulator. The Fed's pure regulatory function should be assumed by either the Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation.
- **Require the Fed to follow a policy rule.** Congress should require the Fed to implement a simple rule that Congress can easily monitor and use to hold the Fed accountable. The rule should provide a clear link between the interest rate target and macroeconomic indicators such as inflation, the output gap, or unemployment. The degree to which the Fed responds to such indicators, as well as other details, might be left to Fed officials to decide. However, it is imperative that once Fed officials decide on a rule, they are required to either follow it or publicly explain any deviations from it.
- **Shrink the Fed's balance sheet and reestablish a scarce reserves regime.** In a scarce reserves regime, instead of holding substantial reserve balances, banks would economize on reserves. To make up for temporary reserve shortages, banks would turn to either the private repo market or the Fed's Standing Repo Facility. To ensure that the Fed returns to a scarce reserves regime, Congress should insist that the Fed follow the 2006 Financial Services Regulatory Relief Act, a law that stipulates that the rate of interest the Fed pays on reserve balances should not exceed the general level of short-term interest rates.⁶

SUGGESTED READINGS

A Comprehensive Evaluation of Policy Rate Feedback Rules by Jai Kedia and Norbert Michel, Cato Institute Policy Analysis no. 987 (January 14, 2025)

Fed's Asset Purchases Result in Increased Market Volatility by Jai Kedia, *Cato at Liberty* (blog), Cato Institute (May 6, 2024)

Pandemic Policymaking Warrants Narrower Fed Mandate by Jai Kedia, *Cato at Liberty* (blog), Cato Institute (December 6, 2023)

New Cato Study Confirms Fed Cannot Control Inflation by Jai Kedia, *Cato at Liberty* (blog), Cato Institute (November 6, 2023)

Ambiguous Economy Is the Latest Result of Fed's Increased Discretionary Behavior by Jai Kedia, *Cato at Liberty* (blog), Cato Institute (June 13, 2023)

The Menace of Fiscal QE by George Selgin, Cato Institute (2020)

Floored!: How a Misguided Fed Experiment Deepened and Prolonged the Great Recession by George Selgin, Cato Institute Working Paper no. 50 (November 15, 2018)