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Reforming the Federal Reserve, Part 9

Dispelling Myths About the Fed

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The American monetary system is based on the fiat US dollar. Consequently, a government entity is ultimately required to ensure that the currency circulates. Congress has made the Federal Reserve that entity, though the Fed does much more than circulate currency, a function that only requires managing the official monetary base. Moreover, Congress has steadily expanded the Fed's reach in areas such as emergency lending and financial regulation, and it has given the Fed a great deal of discretion to fulfill its many legislative mandates. Indeed, the Fed is now a very different institution from what Congress created in 1913.

Partly because of its outsized reach and responsibilities, the Fed is constantly targeted by all kinds of critics. As we have argued throughout this series, the Fed serves the US public best when it does less, not more, and an overly active central bank undermines free enterprise and increases risk within the financial sector. Regarding both the Fed's monetary and nonmonetary functions, getting policy wrong can lead to harmful economic outcomes, as has happened numerous times in the past.[1] Still, many popular ideas for reforming the Fed miss the mark, as they often misread what the Fed controls and overestimate how much unique influence it really has on economic activity. Unfortunately, these myths and misperceptions often hinder serious discussions about policy improvements that would allow the Fed to better operate in a free-enterprise economy.

In this briefing paper, the last in the series, we address the main Fed-related myths and misconceptions about monetary policy that hinder the implementation of positive policy changes. As we have argued throughout the series, ideally the Federal Reserve operates with transparency and predictability while minimizing interference in the markets. As long as the fiat US dollar remains the foundation of the American monetary system, making the Fed as passive an institution as possible is the best possible outcome.[2]


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MYTHS AND MISPERCEPTIONS

To ensure good policy outcomes, members of Congress do not need to understand all the intricate details of monetary policy, but they must avoid falling for the many myths surrounding what the Federal Reserve does. Too often, the Fed is praised or criticized for factors it only marginally affects, including the arguably overstated impact of monetary policy on interest rates and inflation.[3]

Perhaps because of this excessive scrutiny, many members of Congress view the Fed's current structure and level of activity as essential for the fate of the entire economy. The truth is that changes to reduce the Fed's role could improve Americans' lives without imperiling the economy. Given how entrenched the Fed has become in the minds of Americans as its responsibilities have grown, it has become even harder to envision a free market for currency or an economy without a modern central bank. Objectively, though, the private sector is capable of issuing money, and economies can exist and flourish without a central bank.

Part of the problem is that the Fed's operations have become increasingly broad and obscure. Over time, as a consequence of statutory changes and discretionary actions, the Fed has suffered from mission creep, ill-defined mandates, and poor outcomes. Too frequently, the Fed has been able to hide behind its "independence," but the central bank must be answerable to US voters through their elected representatives in Congress. As virtually all central banks do, the Fed has repeatedly argued for more discretionary authority. But economic outcomes are better when the Fed acts objectively and in a predictable, transparent manner.[4]

In this final paper of our series, we highlight three commonly believed myths about the Fed. By dispelling these myths, we hope that policymakers will start to acknowledge that the ideal central bank operates transparently and predictably with minimal interference in private enterprise.

MYTH 1: THE FED "CONTROLS" THE ECONOMY

It might be surprising for many readers, but the Fed's effect on the economy is often weak and indirect, despite its official dual mandate to achieve stable prices and full employment. Given the media attention surrounding the Fed's regular meetings, it is not surprising that people believe that the Fed controls the economy, as if it were pulling levers to get just the right economic outcomes. For instance, a 2022 *Politico* poll showed that 74 percent of US voters believed that the Fed has "a lot of control" or "some control" over inflation.[5]

One reason so many assume that the Fed closely controls the price level is due to a misreading of Milton Friedman's famous assessment that inflation is always and everywhere a monetary phenomenon. Friedman's assessment was correct, but too many have taken it to mean that *only* the Fed, by increasing the supply of dollars, causes inflation. One problem with this overly strict interpretation of Friedman's assessment is that around 90 percent of the US money supply is created by private financial institutions. Setting even that fact aside, the amount of money in circulation does not solely determine the price level. Adherence to this viewpoint is usually the result of drawing spurious inferences from the quantity theory of money, which provides the famous equation of exchange:

$$\text{Price level } (P) \times \text{Real output } (Y) = \text{Money supply } (M) \times \text{Velocity of money } (V)$$

On the surface, prices and money appear to be proportionally related in the $PY = MV$ equation. But this is only a cursory explanation. If all changes in the money supply led to corresponding changes in the price level, then real money balances—the nominal money supply divided by the aggregate price level—would remain relatively stable. This is because any increase in M (the numerator) would be offset by a corresponding increase in P (the denominator), keeping the overall fraction approximately constant over time. Data, however, show that this relationship does not hold; in fact, real money balances have been sharply increasing since the mid-1990s, growing at an average rate of 6.5 percent per year since 1995.

The direct relationship between M and P rests on two assumptions: that the velocity of money (V) is constant and that M has no effect on Y. The first is no longer true, and the second is only true in the long run.[6] Additionally, with several private financial devices being innovated since the creation of this model, it has become increasingly harder to classify "money" and easily define a "correct" measure of M.[7] The correct way to interpret Friedman's dictate is that inflation is caused by a discrepancy in the demand and supply of liquid funds, and the causes of such imbalances could be a variety of factors, only one of which is the Fed. In any case, Friedman's dictate should not be taken to mean that the Fed has precise control over inflation or even *M*.

The Fed certainly does not control, nor does it purport to control, long-term borrowing costs, such as mortgage rates or long yield bonds. Instead, modern monetary policy has relied on the Fed's ability to affect borrowing conditions by altering the short-term rate at which banks lend overnight reserves to each other—the federal funds rate (FFR). Even this method is imprecise and has become much less effective since the 2008 financial crisis, when the Fed adopted new monetary policy tools such as quantitative easing and paying interest on reserves. For financial instruments with short-horizon maturities, the Fed's effect has waned significantly since 2008, and these are the aspects of the financial economy over which the Fed exerts the most control.[8]

By attempting to influence short-term borrowing rates through the FFR, the Fed seeks to alter macroeconomic variables such as inflation and output, but it does not have precise control. For instance, in the short run, adverse supply shocks—such as those caused by a war or the COVID-19 pandemic—cause prices to rise even when the demand for goods remains relatively unchanged. In fact, our research shows that such supply factors overwhelmingly drive inflation. 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.[9]

MYTH 2: THE FED MUST BE COMPLETELY INDEPENDENT

Many people assume that the Federal Reserve should be independent and that it has always been independent. This first assumption is incomplete, and the second is incorrect. In fact, the full history of the Fed helps clarify the correct way to view Fed independence.

Many public banks that eventually became central banks were established to assist their government's borrowing needs—that is, they were designed to enable government borrowing through direct purchases of government debt. Government debt management and monetary policy were directly connected at the Fed prior to 1951. In 1951, however, the US Treasury and the Fed agreed to separate these functions, and many scholars feel this accord set the foundation for modern "independent" monetary policy.[10]

Even after the 1951 agreement, there have been many instances of US presidents, including Dwight D. Eisenhower, Richard Nixon, and Ronald Reagan, interfering with the monetary affairs of the Fed.[11] It makes perfect sense to leave the implementation of monetary policy up to the people running the Fed, but without the interference of politics, the Fed is not required to be so "independent" that it is no longer accountable to the American public through their elected representatives.[12]

In fact, even Milton Friedman argued that the Fed should be brought under the direct control of Congress or the Treasury to ensure political accountability. In 1984, he argued that the existing operating structure of the Fed—which, incidentally, is essentially the same now as it was then—was intolerable in a democracy and that "aside from the economic effects," it was not "an acceptable political system."[13] While he did believe that bringing the Fed under the direct control of the Treasury or Congress might result in more small policy mistakes, he thought it would prevent major disasters.

As this discussion suggests, there are multiple aspects to the concept of Fed independence. For instance, an independent Fed's monetary policy actions would be separated from the government's borrowing operations. This type of independence is critical because, in its absence, the Treasury (the executive branch) could use the central bank to artificially prop up the nation's borrowing, possibly without the consent of Congress and despite negative economic consequences.[14]

An independent Fed's leadership would make monetary policy decisions separately from the administration's political decisions. This kind of independence, sometimes referred to as operational independence, would compel the Fed to set monetary policy based on objective economic benchmarks rather than political goals. This type of independence is especially important because politics will nearly always push the Fed to take more action on monetary policy, even when doing so risks negative economic consequences. Crucially, this form of independence does not imply that the Fed should be free to do whatever it likes with monetary policy; rather, it means that monetary policy should be free from the executive's political considerations.

Other critics of the Fed have made various claims about its independence, including that the Fed is nominally run by the government but is really a private institution. Many have called for the Fed to be audited, arguing that it operates with no oversight at all. Both of these claims are incorrect.

Although the Fed's monetary policy decisions are not subject to audits, the Federal Reserve Board of Governors and the 12 Federal Reserve banks are subject to several levels of audit and review, including audits by the Government Accountability Office.[15] The Fed's financial statements are audited annually by an independent auditor, and a wealth of information on its securities holdings is publicly available.

While the 12 Federal Reserve district banks are not federal agencies, the Federal Reserve Board of Governors is a federal agency, with members appointed by the US president. While some legal scholars question the constitutionality of the Fed's somewhat unique structure, it is undeniable that, starting in the 1930s, Congress restructured the Fed into a primarily public-facing institution controlled by a federal agency (the Board of Governors).[16]

Regardless of the type of Fed independence, some level of accountability for the Fed is important. All monetary policy actions have at least some fiscal consequences, and the Fed's operations can have real economic effects on Americans lives. Thus, Americans should be able to hold the Fed accountable. In theory, voters can hold the Fed accountable through their elected representatives, but in practice it is very difficult to evaluate the Fed's monetary policy decisions because Fed officials have so much discretion, which we will discuss next.

MYTH 3: THE FED PERFORMS BEST UNDER DISCRETIONARY AUTHORITY

The Fed has become increasingly discretionary over time, specifically since its adoption of untested and unsound monetary policy practices following the 2008 recession. Members of the Fed—and most central bankers—have routinely defended a discretionary approach to monetary policy, arguing that placing guardrails on their scope and powers dangerously limits their ability to implement effective monetary policy.[17] For instance, many central bankers argue that central banks need wide discretion to act, especially when faced with the threat of a severe economic downturn. Others argue that because they possess unique insights into the workings of the US economy, they should be allowed to adjust policies as they see fit. The truth, however, is that the Fed is not an all-powerful, all-knowing organization and that economic outcomes are better when the Fed operates with clarity and objectivity.[18] Moreover, if Congress believes that the federal government should use taxpayer funds to prop up businesses or to redistribute income to any group of Americans, it can provide such funds openly and directly.

The Fed's 2020 framework review perfectly encapsulates the problems with the Fed's increasingly discretionary approach. For instance, the Fed committed to "broad-based and inclusive" goals for employment in response to the pandemic.[19] Presumably, this implied that the Fed was not only stabilizing the economy-wide unemployment rate but also using policy tools to affect the distribution of employment across various socioeconomic factors.[20]

It should not be the task of a central bank to pick winners and losers in the labor market. Moreover, there is no clear tool the Fed possesses to affect such distributional outcomes. The Fed implemented this mandate through excessively loose monetary policy and by keeping the FFR target low, with the goal of maintaining tight labor market conditions, as such conditions correlate with a reduced gap in unemployment by race. The Fed continued to keep rates low even as inflation began to rise. Thus, partly due to its commitment to these broad-based and inclusive goals, which the Fed created on its own, inflation ended up higher than it would have been had the Fed adhered more closely to its legislative mandate. Still, even the Fed's legislative mandate to maintain price stability leaves it with an enormous amount of operational discretion.

In fact, the Fed also became increasingly discretionary in its response to inflation. While the Fed has had an explicit 2 percent inflation target since 2012, it legally has the discretion to set that target at any value and even to forgo an explicit target. The 2020 framework review adopted the flexible average inflation targeting approach to influencing inflation, under which the Fed pledged to target an average inflation rate of 2 percent over a longer but unspecified period. As a result, there could be several periods that experience more than 2 percent inflation that the Fed would not address, since it was managing inflation over a discretionary time interval. The Fed also committed to responding only to employment shortfalls and not to employment surpluses, thus signaling a higher tolerance for inflation because employment surpluses can indicate an overheating economy. All these discretionary policy choices undoubtedly caused the Fed to wait too long to raise the FFR target—by the time they did, inflation had increased significantly and had become entrenched.

Admittedly, the Fed has recognized the failures of its 2020 framework review and reversed some of its overly discretionary policies in its 2025 framework review.[21] But these actions are not sufficient. As long as the Fed retains a legislative mandate with so much discretion, it cannot credibly commit to objective monetary policy. The most effective way for the Fed to set the interest rate target is to follow a monetary policy rule.[22] The Fed should also explore other ways to limit its footprint on the economy and allow prices to accurately reflect market signals. However, Congress will have to amend the Fed's legislative mandate to ensure that the Fed acts in this manner.

For instance, the Fed's decision that 2 percent should be the long-run target for the inflation rate is entirely subjective, as it does not use a model or sound economic theory. Ideally, the target rate for inflation should have just as much objective economic foundation as other aspects of monetary policy. One possibility is for the Fed to adjust the target rate for inflation to account for long-term changes to productivity.[23] The benefit of this option is that it acknowledges that, due to widespread increases in productivity, goods and services are now of higher quality and cheaper to produce. Consequently, the reduced cost of providing these goods and services results in lower retail prices for consumers. However, consumers will not experience such savings if the Fed always seeks to increase prices by 2 percent year over year.

CONCLUSION

The Federal Reserve has long been criticized by those who want to reform or even get rid of it. While there are many ways to reform the Fed that could improve the US economy, the American monetary system is currently dictated by the fiat US dollar. Provided this situation remains unchanged, simply closing the Fed is not a viable policy option.

As we have argued in this series, the Fed is much different than the institution Congress created in 1913, with reach and responsibilities well beyond what is needed to fulfill its crucial function of ensuring that the US dollar circulates. When it comes to both the Fed's monetary and nonmonetary responsibilities, the wrong policies can lead to harmful economic outcomes. Indeed, the Fed would best serve the public by doing less, not more, and an overly active Fed undermines the market system and free enterprise.

Still, many popular ideas for reforming the Fed misread what the Fed controls and how much influence it really has on economic activity. Unfortunately, these myths and misperceptions impede serious policy improvements. In this paper, the last in the series, we highlight three such myths. By dispelling these myths, we hope that more policymakers will be open to reforming the Fed so that it operates with more transparency and predictability while minimizing interference in the private sector.

NOTES

1. George Selgin et al., "Has the Fed Been a Failure?," *Journal of Macroeconomics* 38, no. 3 (September 2012): 569–96.

2. Along with passing many reforms to the Fed, Congress should ensure that the US legal framework does not prevent private alternatives from flourishing. See James A. Dorn, *Monetary Alternatives: Rethinking Government Fiat Money* (Cato Institute, March 2017); Norbert Michel, "An Updated Interview with George Selgin on Free Banking and Bitcoin," *Cato at Liberty* (blog), Cato Institute, July 25, 2025; and Nicholas Anthony, "Congress Should Welcome Cryptocurrency Competition," Cato Institute Briefing Paper no. 138, May 2, 2022.

3. Jai Kedia, "Has Fed Policy Mattered for Inflation? Evidence from a Structural Monetary Model," Cato Institute Working Paper no. 78, October 26, 2023.

4. Alex Nikolsko-Rzhevskyy et al., "Deviations from Rules-Based Policy and Their Effects," *Journal of Economic Dynamics and Control* 49 (December 2014): 4–17; and John B. Taylor, "Monetary Policy Rules Work and Discretion Doesn't: A Tale of Two Eras," *Journal of Money, Credit and Banking* 44, no. 6 (September 2012): 1017–32.

5. *National Tracking Poll #2205081* (Morning Consult and Politico, 2022).

6. "Real M2 Money Stock," Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, last updated November 25, 2025; and Robert G. King and Mark W. Watson, "Testing Long-Run Neutrality," Federal Reserve Bank of Richmond *Economic Quarterly* 83, no. 3 (Summer 1997).

7. Pedro Teles et al., "Is Quantity Theory Still Alive?," *Economic Journal* 126, no. 591 (March 2016): 442–64.

8. Jai Kedia, "Borrowing Rates Much Less Correlated with Fed's Policy Rate," *Cato at Liberty* (blog), Cato Institute, October 24, 2024.

9. Jai Kedia, "Has Fed Policy Mattered for Inflation? Evidence from a Structural Monetary Model," Cato Institute Working Paper no. 78, October 26, 2023.

10. See part 1 of our series, Norbert Michel and Jai Kedia, "Reforming the Federal Reserve, Part 1: A Brief Look Back and the Way Forward," Cato Institute, April 18, 2025.

11. Norbert Michel, "The Fed Has Not Been Independent—Perhaps It Should Be Restructured," *Forbes*, March 19, 2019.

12. Separately, there is evidence that the Board of Governors is becoming more involved in selecting Reserve Bank board members, giving it increased control over the appointment of the people who are arguably closer to the public (and who are overwhelmingly more likely to dissent). Jeffrey Lacker, "Governance and Diversity at the Federal Reserve," Mercatus Center at George Mason University, January 8, 2024.

13. Milton Friedman, "Monetary Policy Structures," *Cato Journal* 34, no. 3 (Fall 2014).

14. Norbert Michel and Jai Kedia, "Reforming the Federal Reserve, Part 8: Preventing Fiscal Dominance," Cato Institute, September 25, 2025.

15. Though monetary policy decisions are not audited, the Fed releases transcripts of Federal Open Market Committee meetings with a five-year delay. See "Transcripts and Other Historical Materials," Federal Open Market Committee, Board of Governors of the Federal Reserve System, updated January 28, 2022.

16. Peter Conti-Brown, *The Power and Independence of the Federal Reserve* (Princeton University Press, October 10, 2027), pp. 103–26.

17. Jai Kedia, "The Fed's Critiques of Rules-Based Monetary Policy Are Invalid," *Cato at Liberty* (blog), Cato Institute, February 11, 2025.

18. Norbert Michel and Jai Kedia, "Reforming the Federal Reserve, Part 2: Enforcing Rules-Based Monetary Policy," Cato Institute, April 30, 2025.

19. Board of Governors of the Federal Reserve System, "Federal Open Market Committee Announces Approval of Updates to Its Statement on Longer-Run Goals and Monetary Policy Strategy," press release, August 27, 2020.

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

21. Sylvain Leduc et al., "A Roadmap for the Federal Reserve's 2025 Review of Its Monetary Policy Framework," FEDS Notes, Board of Governors of the Federal Reserve System, August 22, 2025.

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

23. George Selgin, *Less Than Zero: The Case for a Falling Price Level in a Growing Economy* (September 2018).