Reforming the Federal Reserve

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Cato Institute
1000 Massachusetts Ave. NW
Washington, DC 20001
www.cato.org

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Section 1.
A Brief Look Back and the Way Forward

Created in 1913, the Federal Reserve is one of the most misunderstood and controversial arms of the US government. The Fed's harshest critics blame it for virtually every economic disturbance, and some want to eliminate it.[1] Yet its staunchest supporters want to expand its powers to help the government directly fund all sorts of economic activity. Regardless of their preferences, both critics and supporters must admit that the Fed has many responsibilities Congress never intended when establishing it.

The Fed is now tasked with achieving specific macroeconomic goals, providing fiscal support to the federal government, regulating thousands of banks and other financial institutions, engaging in credit allocation to private institutions, and operating core components of the payment and settlement system.[2] It is undeniable that, with these increased responsibilities, the government has become more involved in people's economic decisions.

While many policymakers still debate whether increasing government involvement or expanding economic freedom is the best way to create more economic opportunity and prosperity, few bother to extend this debate to the provision of money. Some economists even argue for *increased* centralization and government control of money despite acknowledging that the "biggest threat to the value of the currency is often the government itself."[3] And some even want to force people to use central bank digital currencies (CBDCs) so that the government can more easily charge "deeply negative interest rates."[4]

Still, decades of experience have demonstrated that poorly executed monetary policy can have severe consequences, and that the government's actual record of monetary stewardship is poor.[5] Ideally, Congress would make monetary policy more transparent and predictable by shrinking the Fed's discretionary authority while also allowing private currencies to compete with the dollar. Such reforms would provide a powerful check on the government's ability to diminish the quality of money. This paper is the first in a series that discusses the Fed's many roles, why they should be more limited, and how they can be curtailed.

THE FED WAS NOT CREATED FOR MODERN MONETARY POLICY

Monetary policy as it is known today was not even possible in the Fed's early decades. Until the 1930s, Federal Reserve notes were freely convertible into gold. Under that system, the quantity of dollars, their purchasing power, and monetary conditions generally were ultimately determined by the supply of and demand for gold rather than Fed policy. Although the Fed did have some influence, especially in the short run, in the longer run the system was self-regulating.

For many reasons, including poorly designed rules and regulations, banks during the pre-Fed era were unable to freely issue notes (paper currency).[6] As a result, they often had no choice but to part with high-powered reserves instead of issuing more notes. To alleviate this problem, banks tried various arrangements, including the establishment of clearinghouses that served as centrally located markets for banks to acquire reserves.[7] Still, none of these arrangements proved sufficient to always allow banks, either directly or with clearinghouses' help, to supply enough paper currency to meet the public's needs.[8]

Instead of loosening restrictions on the banks' ability to issue notes, Congress chose to establish the Federal Reserve System with the stated goal of providing the "elastic currency" needed to fill the gaps.[9] In establishing the Fed, Congress nationalized services previously performed by private clearinghouses, giving the federal government more

control over the supply of money.[10] After 1933, the gold standard was abandoned in stages, and monetary policy now involves deliberately and directly regulating the supply of fiat money with the aim of economic stabilization.[11]

THE FED CONTROLS THE MONETARY BASE

The US monetary framework has evolved considerably and, unlike in the early 1900s, the economy's *base* money is now a fiat currency controlled by the US government. Specifically, the Fed is now the monopoly supplier of the base money used in the US economy.[12] That is, the Fed is the sole supplier of the money upon which all other mediums of exchange in the economy are based.[13] This relationship limits how Congress can change the Fed because the supply of the base is no longer directly tied to market forces, as it was when money was directly convertible into precious metals. Regardless of how beneficial many monetary reforms might be, eliminating the Fed without consideration for the monetary base would be economically disruptive.

The monetary base is sometimes referred to as high-powered money because an increase in the base allows banks to create more money. Private banks also hold base money as reserves to serve as a source of currency for customers' cash withdrawals and to settle accounts with other banks. The greater the availability (or the lower the cost) of reserves, the more loans and deposits banks can create and administer.[14] Thus, managing the relationship between the publicly supplied base and broader, privately created money is how the Fed conducts monetary policy.[15]

Still, this limited relationship between the base and privately supplied money serves as a cautionary tale for policymakers. Although the monetary base is a key part of the larger money supply, most money in the United States is created by the private sector. In fact, private banks generally have created most of the money used in the United States, with that share fluctuating around 90 percent of the total US money supply for decades.[16] This fact serves as a warning for those who view the Fed as an all-powerful institution that can actively fine-tune economic outcomes. The Fed does not have direct control over the broader money supply, prices, unemployment, or even lending activity. It *influences* private economic activity by altering the cost or availability of the monetary base.

Provided that the fiat US dollar remains the base currency in the US economy—as well as the world's most sought-after reserve currency and favored settlement medium for international trade—some government entity must administer its supply. It does not follow, however, that the current monetary policy framework is optimal or that people should be prevented from using other forms of privately created money. Moreover, monetary policy cannot be viewed as wholly divorced from fiscal policy. The federal government's fiscal operations can, at the very least, make it more difficult for the Fed to successfully conduct monetary policy.

THE FED SUPPORTS FISCAL OPERATIONS

The Federal Reserve Act originally authorized the Fed to purchase US government securities. However, the intent was for the Fed to operate mainly by purchasing privately issued securities such as bankers' acceptances, trade acceptances, and bills of exchange.[17] There was, in fact, a general view that regular Fed purchases of federal debt would be seen as "lending to the crown."[18] With the onset of World War I, this view changed. By 1920, Treasury securities made up 60.6 percent of the Fed's holdings. By 1934, the share was 100 percent.[19]

The Fed now serves a broader fiscal-agent role than first envisioned, providing the federal government with various services related to federal debt, including conducting the auctions in which the US Treasury sells its debt securities.[20] Prior to World War II, the market for US Treasury securities was much less robust than it is today, so Federal Reserve purchases of Treasurys gave more direct support to the US government's efforts to finance its operations.[21]

While the federal government can easily sell debt without direct central bank support, the interaction between fiscal and monetary policy remains a critical factor in determining the overall price level in the economy.[22] Large amounts of deficit-financed expenditures, for instance, can induce inflation and make monetary policy goals difficult to achieve.[23] Moreover, if the Fed monetizes too much federal

debt, it can also induce inflation. Regardless, the role of the Fed in monetizing debt is not new, nor will it cease unless Congress handcuffs the Fed's discretionary abilities.

CONSTRAINING THE FED AND EXPANDING INDIVIDUAL LIBERTY

The Fed is unnecessarily enmeshed in many tasks beyond Congress's original intent for the central bank. For example, the Fed regulates thousands of banks and other financial institutions, and it holds the reserves of all commercial banks and many other financial institutions.[24] As a result, the Fed has a conflict of interest in lending to firms under its regulatory purview. Instead, Congress could require one of the other federal banking regulators, such as the Office of the Comptroller of the Currency, to execute the Fed's regulatory functions.[25] Since its creation, the Fed has also progressively taken over parts of the payments system that originated with private sector innovations such as check clearing and settlements.

The Fed has also involved itself in direct credit allocation, sometimes by creating ad hoc lending facilities or by making so-called emergency loans.[26] Congress should curb the Fed's ability to lend in this manner because the Fed can implement monetary policy without lending directly to individual firms, which, among other things, exacerbates the "too big to fail" problem and imperils the broader financial system. To fulfill its function as lender of last resort, the Fed can expand open-market operations and provide liquidity to the entire system, allowing banks to access that liquidity through the (private) federal funds market.[27]

These other functions can sometimes complicate the implementation of monetary policy, and they are not essential. Regardless, the Fed should not be relied on to successfully fine-tune the economy—no group of government officials should be expected to do so. In an ideal world, Congress would not have created a central bank or expanded the government's role in money to the degree that it has. Nonetheless, within the existing monetary system, some sort of central authority remains necessary to administer the supply of base money.

Merely getting rid of the Fed without creating a new authority would be economically disruptive because it would effectively mean getting rid of the dollar. It does not follow, however, that the current arrangement is optimal even for monetary policy. For instance, restricting the Fed's operations so that monetary policy is transparent and predictable would ensure that the Fed disrupts individuals' economic decisions much less than it does currently, thus more closely approximating a free enterprise system. The best way for Congress to achieve this goal would be to require the Fed to follow a policy rule.[28]

Of course, as the several rounds of government expenditures after the COVID-19 pandemic demonstrate, even if Congress constrains the Fed with a monetary policy rule, Congress can still induce inflation through fiscal policy. Thus, Congress should enact long-term reforms that fix the nation's unsustainable fiscal path.[29] Additionally, to ensure that the Fed cannot monetize excessive debt at its own discretion, Congress should limit the size of the Fed's balance sheet and restrict the Fed from purchasing anything other than short-term Treasury securities.

CONCLUSION

The operational history of the Federal Reserve is marred with poor policy decisions. However, if the monetary system of the United States remains based on the fiat US dollar, a government entity is required to determine the amount of that currency available in circulation. Yet the Fed, with activities ranging from emergency lending to financial regulation, does far more than simply managing the supply of the monetary base.

The Fed serves the US public best when it does less, not more. The ideal Federal Reserve System would operate with more accountability, transparency, and predictability while minimizing interference in private markets. Rejecting increased government intervention in favor of expanding free enterprise is the best way to reduce needless economic uncertainty, help Americans create more economic opportunity, and improve living standards. This briefing paper is the first in a series that will examine the Fed's various functions and propose reforms to ensure that it operates in a manner consistent with limited government and a free-market economy.

NOTES

1. "Rep. Massie Introduces Federal Reserve Board Abolition Act to 'End the Fed'," press release, Congressman Thomas Massie, March 5, 2025.

2. "Why Elon Musk Is Wrong About the Federal Reserve," press release, US House Committee on Financial Services Democrats, December 27, 2024.

3. Kenneth S. Rogoff, *The Curse of Cash: How Large-Denomination Bills Aid Crime and Tax Evasion and Constrain Monetary Policy* (Princeton University Press, 2016), p. 19.

4. The idea is that negative interest rates (e.g., penalties for people who fail to spend "enough" during downturns) would help improve monetary policy. Kenneth Rogoff, "COVID Coin?," *Project Syndicate*, August 5, 2020.

5. George Selgin et al., "Has the Fed Been a Failure?," *Journal of Macroeconomics* 34, no. 3 (September 2012): 569–96.

6. George Selgin, "New York's Bank: The National Monetary Commission and the Founding of the Fed," Cato Institute Policy Analysis no. 793, June 21, 2016.

7. Richard H. Timberlake, "Clearing House Currency," *Cato Journal* 34, no. 2 (Spring/Summer 2014): 303–14.

8. For additional information on how government regulations prevented the supply of money from being sufficiently elastic prior to the creation of the Fed, see George Selgin, "The Suppression of State Banknotes: A Reconsideration," *Economic Inquiry* 38, no. 4 (October 2000): 600–15; and George Selgin, "Accommodating Changes in the Relative Demand for Currency: Free Banking vs. Central Banking," *Cato Journal* 7, no. 3 (Winter 1988): 621–41.

9. Of course, even though the pre-1913 monetary system was unstable, it does not follow that the creation of the Federal Reserve System was the best solution. Indeed, the Federal Reserve Act made it easy to produce an expansive currency, but not one that would easily contract when additional currency was not needed—even though the framers of the Fed did use the term "elastic currency." See George Selgin, "A Prescient Fed Critic," *Cato at Liberty* (blog), Cato Institute, September 5, 2015.

10. Member banks were able to borrow at the Fed's discount window to turn illiquid loans into liquid currency, thus providing a mechanism to produce an "elastic" currency. See David C. Wheelock, "Overview: The History of the Federal Reserve," Federal Reserve History, September 13, 2021.

11. A fiat currency is one that is not convertible (or pegged) to a physical commodity like gold or silver. Instead, the currency is "backed" by nothing more than the issuing government's promise to issue more of it.

12. The "monetary base" refers to the total quantity of the Fed's own dollar liabilities, consisting mainly of Federal Reserve Notes and banks' deposit balances with the Fed (i.e., reserve balances).

13. Fundamentally, all other dollars (e.g., commercial bank deposits) represent the base dollars into which they can be converted.

14. See George Selgin, *Floored!: How a Misguided Fed Experiment Deepened and Prolonged the Great Recession* (Cato Institute, 2018).

15. The degree to which increases in the monetary base lead to increases in private money supply is called the money multiplier effect and occurs as banks loan out base money, which in turn is deposited in other banks and financial institutions. These banks then continue the chain of lending and depositing, resulting in a greater than one-for-one increase in private money because of increased base money. The Fed has limited control over the money multiplier, and the scale of the effect has decreased significantly over time.

16. This calculation takes the currency in circulation (part of the monetary base) out of the broader M2 money supply category. M2 includes bank deposits.

17. David Marshall, "Origins of the Use of Treasury Debt in Open Market Operations: Lessons for the Present," Federal Reserve Bank of Chicago *Economic Perspectives* 26, no. 1 (February 2002): 45–54; and Arthur Reynolds, "Early Functioning of the Federal Reserve System," *Annals of the American Academy of Political and Social Science* 99 (January 1922): 74–79.

18. Many public banks that eventually became central banks were created to assist their government's borrowing needs, a fact that was not unknown in 1913. See George Selgin, "Central Banks as Sources of Financial Instability," *Independent Review* 14, no. 4 (Spring 2010): 485–96; and George Selgin, "One Sentence, or, Unpacking the Truth About the Founding of the Bank of France," *Cato at Liberty* (blog), Cato Institute, January 21, 2016.

19. David Marshall, "Origins of the Use of Treasury Debt in Open Market Operations: Lessons for the Present," Federal Reserve Bank of Chicago *Economic Perspectives* 26, no. 1 (February 2002): 48.

20. "Treasury Debt Auctions and Buybacks as Fiscal Agent," Federal Reserve Bank of New York; and Paula V. Hillery and Stephen E. Thompson, "The Federal Reserve Banks as Fiscal Agents and Depositories of the United States," *Federal Reserve Bulletin*, April 2000.

21. Prior to 1951, government debt management and monetary policy were directly connected; in 1951, the US Treasury and the Fed agreed to separate them. Many scholars feel this accord set the foundation for "independent" monetary policy. See Jessie Romero, "The Treasury-Fed Accord, March 1951," Federal Reserve History, November 22, 2013.

22. Eric Leeper, "Fiscal Dominance: How Worried Should We Be?," Mercatus Center at George Mason University, April 3, 2023.

23. In such a case, the Fed would have to be willing to tighten its policy stance (i.e., increase its rate target) sufficiently to prevent inflation. Historically, the Fed has been hesitant to act in such a manner.

24. Prior to 1980, only commercial banks that were members of the Federal Reserve System were required to hold reserves with the Fed, and by 1980, less than 40 percent of all commercial banks were members of the system. The Depository Institutions Deregulation and Monetary Control Act of 1980 required all banks to hold their reserves at the Fed. See Kenneth J. Robinson, "Depository Institutions Deregulation and Monetary Control Act of 1980, March 1980," Federal Reserve History, November 22, 2013.

25. Norbert Michel, "There Are Many Ways to Fix Bank Regulation—Here's a Start," *Cato at Liberty* (blog), Cato Institute, December 16, 2024.

26. Norbert Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation Backgrounder no. 2943, August 20, 2014.

27. Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy, and Central Banking," Federal Reserve Bank of Richmond *Economic Review 74* (May/June 1988): 3–22; and Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review* 74, no. 5 (September/October 1992): 58–69.

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

29. Romina Boccia and Dominik Lett, "The Threat of Fiscal Dominance: Will the US Resort to Money-Printing to Finance the Rising Debt Challenge?," *Cato at Liberty* (blog), Cato Institute, April 4, 2024.

Section 2.
Enforcing Rules-Based Monetary Policy

Congress requires the Federal Reserve to promote price stability and low unemployment, but the Fed has no binding requirements on how to achieve that mandate. For many observers, this mandate has morphed into the notion that the Fed "manages" the entire economy, adjusting interest rates as it sees fit to dial in some precise inflation or output target. But that notion gives the Fed too much credit: It is unreasonable to expect any agent, even a group of central bankers, to accomplish such economic fine-tuning. Among other problems, this simplistic thinking glosses over the role of other economic agents and random shocks that are all interlinked within the complex workings of the US economy.

Still, poorly executed monetary policy can have severe consequences, and the government's poor record of monetary stewardship is sufficient cause for reforming the Fed. Importantly, as long as the fiat US dollar remains the base money for the American economy, then a government entity will have ultimate control over the supply of the economy's base money. Still, there is scope to keep the Fed from worsening economic conditions, even if it cannot provide a salve to every economic ailment. To this end, monetary policy should be clear, concise, predictable, and as immune from political pressure as possible. All these traits are best achieved by eliminating much of the Fed's discretionary authority and requiring it to set its interest rate target using a policy rule.

HOW MONETARY POLICY WORKS

When considering the tools the Fed has at its disposal, it is unreasonable to expect the Fed to achieve precise economic outcomes. For most of the history of monetary policy, the Fed's main tool was buying or selling government securities to increase or decrease the monetary base. It conducted these operations to influence the federal funds rate (FFR)—the interest rate at which banks borrow overnight reserves from each other in the private market—toward a predetermined target. Since the FFR represents the cost at which banks can acquire money to fund their operations, the FFR affected the various rates at which banks were willing to give loans to their customers.

During the 2008 financial crisis, the Fed dramatically changed its operating framework by flooding the banking sector with reserves. Though the Fed often talked of reverting monetary policy to the previous system, this framework has remained in place since the crisis. Whereas the old framework could be characterized as a "scarce reserve" framework, the new framework is referred to as one with "abundant reserves." From 1984 through 2007, the weekly aggregate balance averaged $19 billion. By the end of 2009, however, this total exceeded $1 trillion. Though the amount has fluctuated, it is currently over $3 trillion.

In this type of abundant reserve framework, changing the *quantity* of these reserves no longer affects the FFR. Instead, the Fed now alters the FFR by paying banks interest on reserves (IOR).[1] Banks will not lend to other banks at rates lower than the risk-free rate at which they can collect interest from the Fed. Consequently, changing the IOR rate to affect the cost of holding reserves is now the Fed's main instrument for changing the FFR and thereby conducting monetary policy.[2]

This explanation describes the theory behind how monetary policy is supposed to work, but even when the Fed buys securities or lowers the IOR rate to lower the FFR, private banks still need to issue loans to produce increased economic activity. Likewise, if the Fed sells securities or increases the IOR rate to increase the FFR, private banks have to decrease their lending to slow economic activity.

In either instance, there is no guarantee that the Fed's operations will lead to a precise change in lending that will, in turn, lead to a precise change in the broader money supply, interest rates, prices, unemployment, or overall economic activity.[3]

RULES OFFER THE BEST VERSION OF MONETARY POLICY

While changes in the money supply do not affect the "real" level of economic activity in the long run, they can still affect real outcomes in the short run.[4] Consequently, many economists have long sought ways to use monetary policy to minimize short-run economic disruptions (often called business cycles). Of course, the main tool the Fed uses to minimize these economic disruptions is influencing short-term credit markets, as explained in the preceding section.

For decades, many economists have argued for monetary policy rules to help minimize short-run economic disruptions. For instance, some have argued that the monetary base should be frozen, with private banks creating currencies to fill the demand for money.[5] Others have called for constant growth of the monetary base at a given percentage each year.[6] Most modern macroeconomists advocate for rules that directly determine the target for the FFR rather than rules that govern the growth of the money supply. These rules generally update the target rate in response to current values of macro indicators such as inflation, unemployment, or output growth.[7]

Many central bankers argue that these kinds of monetary policy rules are too restrictive and that they would prevent the Fed from enacting the appropriate monetary policy response to economic changes. Instead, because of the enormous complexity of the economy and its ever-changing nature, they advocate for maintaining a high level of discretion for the Fed to implement monetary policy as it sees fit. But the complex nature of the economy makes the case for rules-based policy even stronger. Since no one person (or small group of central bankers) can be expected to understand and react properly or consistently to changing economic conditions, policy rules would reduce uncertainty among citizens and firms by making the Fed more predictable and transparent.

Committing to a rule would prevent the Fed from raising or lowering its target rate due to political pressure and, therefore, better insulate its policy independence. Rules also help the Fed with forward guidance, allowing the public to more accurately anticipate how the Fed would respond to economic conditions in any future state of the world.[8]

Congress should require the Fed to adopt a rules-based monetary policy to reduce uncertainty by anchoring people's expectations regarding what the Fed will do on a continuous basis.

RULES-BASED OUTCOMES DIFFER RELATIVELY LITTLE

Monetary policy rules were first devised because they are robust to changes in or misperceptions of the underlying structure of the US economy. Even if policy rules do not consistently lead to optimal outcomes, they are preferable to how monetary policy is conducted currently because they never leave the public guessing what the Fed will do next, thus allowing people to more easily adjust their behavior to changing economic conditions. In the absence of rules, the Fed's discretionary policy choices have failed to prevent short-run fluctuations, as was clear with the post-pandemic inflation surge. When central bankers are wrong about the nature of economic relationships, as they were after the pandemic when they labeled inflation "transitory," policy rules offer a superior choice to discretion.[9]

There is some disagreement over which policy rule is the best one. However, many of the standard policy rules are mathematically similar, and they are designed to respond to short-term shocks that move the economy away from its long-term equilibrium path. As other research from Cato's Center for Monetary and Financial Alternatives has shown, debates among experts over the superiority of various rules should not hamper the Fed's immediate commitment to following a rule.[10] Every rule offers a trade-off between potential short-run stabilization benefits and the informational burden it places on the Fed.[11] In general, rules that target inflation, unemployment, and output growth

offer better stabilization but suffer from higher information burdens. Even simple inflation targeting is a feasible choice; while research suggests it would be less stabilizing than the other rules, its simplicity drastically reduces the Fed's informational burden, ensuring that the Fed relies only on its most forecastable variable—inflation.

Since no one rule is plainly best and most rules under consideration are better than discretion, the Fed should decide which of the various trade-offs are most desirable and credibly commit to following the rule associated with those desirable traits. Maximizing predictability and transparency is likely the best that can be achieved given the current monetary framework. To ensure that the Fed and elected officials remain accountable for monetary policy decisions, Congress should require the Fed to adopt rules-based monetary policy.

IMPLEMENTING RULES-BASED MONETARY POLICY

As we have argued, rules are superior to discretion, and disagreements over which specific rule the Fed should follow are not so important as to prevent the Fed from following a rule in the first place. Naturally, it is also important to discuss how such a system would be implemented. A template for implementing this system already exists—the Fed Oversight Reform and Modernization (FORM) Act of 2015.[12] Under legislation such as the FORM Act, the Fed would be required to specify and follow a rule when setting its interest rate target. The choice of which rule would be up to the Fed (or more specifically, to the Federal Open Market Committee), and the rule would be binding only in that once the Fed picked a rule, it would have to follow it unless it explained its deviations from the rule to Congress. Ideally, such a rule should have academic rigor and be clearly specified, unlike the Fed's adoption of flexible average inflation targeting in 2020.[13] The Fed could update the rule at regular intervals, such as at its five-year framework review. Additionally, at each such rule review, the Fed should also update and clarify its target for the inflation rate. It should not always target 2 percent inflation, as the optimal inflation rate can vary with economic conditions, such as long-term productivity changes. The target rate should be chosen with increased academic rigor and within a proper structural framework.

Though many central bankers will likely disagree, such a system would not hamstring the Fed. The Fed could, for instance, update the rule to account for structural changes to the US economy. Additionally, it is possible for exigent circumstances to arise that require an immediate deviation from the rule. An example would be the sudden shutdown of an otherwise healthy economy during the COVID-19 pandemic. Under such unforeseen circumstances, this kind of rules-based policy would allow the Fed to deviate from the stated rule, provided it explains its reasoning publicly to Congress. If the public were to disagree with the Fed's reasoning, it could hold the Fed accountable through its elected representatives more easily than now. Under the current system, it is often difficult to ascertain the exact reasoning behind the Fed's policy moves despite some increases in transparency, such as more-detailed statements from the Federal Open Market Committee and the Fed chairman holding press conferences following policy rate decisions.

CONCLUSION

The Federal Reserve Act requires the Fed to promote price stability and low unemployment, but it places no binding requirements on how the Fed achieves that mandate. Providing the Fed with this level of discretion has made monetary policy more ambiguous and unpredictable than it should be and has left the Fed exposed to too much political pressure. Congress can rectify these problems by requiring the Fed to follow a monetary policy rule.

The exact choice of rule is important, but most popular rules mirror the recommendations of the others—and all of them outperform Fed discretion. Thus, disagreement over the superiority of a single rule should not prevent Congress from requiring the Fed to follow a monetary policy rule. Congress can improve monetary policy outcomes by imposing a rules-based regime on the Fed, and the framework envisioned in the 2015 FORM Act would do so while providing the Fed with sufficient flexibility to operate when unforeseen events arise.

NOTES

1. For more on the rationale behind paying interest on reserves, see Peter Ireland, "Interest on Reserves: History and Rationale, Complications and Risks," *Cato Journal* 39, no. 2 (Spring/Summer 2019).

2. Despite the FFR being the primary focus of monetary policy, flushing the banking sector with reserves has severely diminished the federal funds market since banks no longer need to seek short-term liquidity from other private firms. As a result of the policy framework switch, daily trading volume in the Fed funds market fell from its pre-2008 level of $150–$175 billion to just $60–$80 billion in the mid-2010s. Gara Afonso et al., "Who's Borrowing and Lending in the Fed Funds Market Today?," *Liberty Street Economics* (blog), Federal Reserve Bank of New York, October 10, 2023.

3. Of course, there are various market frictions and economic shocks that also prevent the Fed from achieving exact outcomes, but the point remains that nobody should expect the Fed to precisely manage the American economy.

4. Norbert Michel, "The Fed at 100: A Primer on Monetary Policy," Heritage Foundation Backgrounder no. 2876, January 29, 2014.

5. Ignoring the potential macroeconomic problems of freezing the monetary base, in the absence of some kind of binding constraint, Congress could always increase the base, but this would lead to an overheated economy and/or inflation. Put differently, without an explicit mechanism to prevent them, the United States would still risk the economic disruptions caused by inflation due to Congress's extravagant fiscal policy.

6. The famous version of this policy is Milton Friedman's *k* percent rule. See Milton Friedman, *A Program for Monetary Stability* (Fordham University Press, January 1, 1983).

7. The federal funds rate is the cost of acquiring reserves, so targeting the FFR implies that the Fed is altering the price rather than the quantity of base money. The Fed switched to targeting the funds rate rather than the money supply due to the difficulty of measuring money demand and its unpredictable nature.

8. Forward guidance is a monetary policy tool the Fed adopted in the early 2000s. Under this tool, the Fed provides information to the public about the likely path of monetary policy heading into the future. Consumers and firms can use this information to make present decisions about spending or saving, helping with macroeconomic stabilization.

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

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

11. To accurately set the target for the federal funds rate, the Fed needs accurate estimates of real-time or future macroeconomic data such as inflation, unemployment, and so on. The worse the Fed is at calculating real-time estimates of these variables, the higher the informational burden it places on the Fed.

12. Fed Oversight Reform and Modernization Act of 2015, H.R. 3189, 114th Cong. (2015).

13. Norbert Michel, "Good Politics Versus Good Policy: The Fed's New Average Inflation 'Target,'" *Forbes*, August 31, 2020.

Section 3.
Restoring Sensible Asset Purchases

Since the 2008 financial crisis, the Federal Reserve has vastly expanded its footprint in financial markets through massive asset purchases, commonly referred to as quantitative easing (QE). What began as a temporary emergency response has morphed into a primary feature of modern central banking, resulting in the Fed's balance sheet bloating to historic proportions—expanding from less than $1 trillion in 2007 to nearly $9 trillion at its peak in 2022, largely due to successive rounds of QE.[1] These programs involved large-scale purchases of US Treasury securities and agency mortgage-backed securities (MBS) intended to lower long-term interest rates and stimulate aggregate demand.

While QE was marketed as a necessary step to support economic recovery, the Fed's foray into large-scale asset buying raises serious concerns about fiscal independence and financial stability. To maintain a clear demarcation between monetary and fiscal policy, as well as minimize its footprint on financial markets, the Fed must revert to trading only US Treasury securities and revert its asset-purchase program to its pre-2008 regime.

RATIONALE BEHIND QUANTITATIVE EASING

QE was introduced as an unconventional monetary policy tool when the federal funds rate approached its effective lower bound (i.e., the fed funds rate was effectively zero percent) and, as a result, traditional monetary policy could no longer provide additional stimulus by targeting short-term interest rates. Through QE, the Fed purchased large quantities of *longer-term* Treasury securities and agency MBS to influence broader financial conditions and support economic activity.[2]

The primary theoretical justification for QE lies in its ability to reduce long-term interest rates by altering the composition of assets held by the public. By absorbing large volumes of long-duration securities, the Fed aimed to compress term premiums (i.e., lower the additional compensation for holding longer-term assets versus short-term assets), thereby encouraging greater borrowing and investment.[3] In addition, rising asset prices were expected to boost household wealth and stimulate consumption—a transmission channel often referred to as the wealth effect.

QE was also intended to serve a signaling function. By undertaking large-scale purchases, the Fed sought to reinforce its commitment to accommodative policy for an extended period, helping anchor market expectations of low future short-term rates. Finally, during periods of financial distress, QE was thought to inject liquidity into key markets, stabilize asset prices, and restore investor confidence.

There is wide debate as to whether QE worked as intended and helped the recovery from the recession.[4] Regardless, QE has undoubtedly bloated the Fed's balance sheet and led to undesired interactions with financial markets and fiscal policy beyond the Fed's traditional role.

FED'S SIZE DISRUPTS FINANCIAL MARKETS

The multiple rounds of QE following the 2008 recession and again following the COVID-19 pandemic have drastically increased the size of the Fed and fundamentally changed its relationship with the financial sector. Figure 3.1 shows the Fed's asset holdings as a percentage of all the assets held by US commercial banks. Prior to the 2008 financial crisis, the Fed's balance sheet rarely exceeded 10 percent of the commercial banking sector, with the trend exhibiting a gentle decline. After the financial crisis, however, the Fed entered a new era, with this number

frequently exceeding 20 percent. The QE operations during the pandemic led to another structural jump, with the Fed reaching 40 percent of the size of all commercial banking.

Such a large shift in central banking has effects on the financial system. The primary effect of the Fed's interference in asset markets is the massive reduction in reserves trading between private banks through the federal funds market. In return for the Treasurys and MBS the Fed purchased, those funds drastically increased the reserves of financial institutions, moving from a scarce-reserves regime prior to 2008 to an abundant-reserves regime. Under the new framework, banks were so flush with reserves that they no longer needed to borrow them from other banks. As a result of the policy framework switch, daily trading volume in the fed funds market fell from its pre-2008 level of $150–$175 billion to just $60–$80 billion in the mid-2010s.[5] Consequently, the fed funds rate, the Fed's key policy rate, has become much less correlated with other borrowing rates.[6]

This shift in framework has also had serious repercussions for financial markets.[7] Before the 2008 financial crisis, increases in the Fed's balance sheet typically led to minor *reductions* in market volatility; after the crisis, balance sheet increases are accompanied by large *increases* in market volatility. Research from the Cato Institute shows that since 2008, a 1 percent increase in assets may cause a 6 percent increase in financial market volatility.[8] Market participants may now view Fed asset changes as a signal of weakening economic conditions due to the scale and frequency of QE measures. Conversely, before 2008, balance sheet expansions were less common and typically viewed as a routine adjustment or a response to relatively minor financial disruptions.

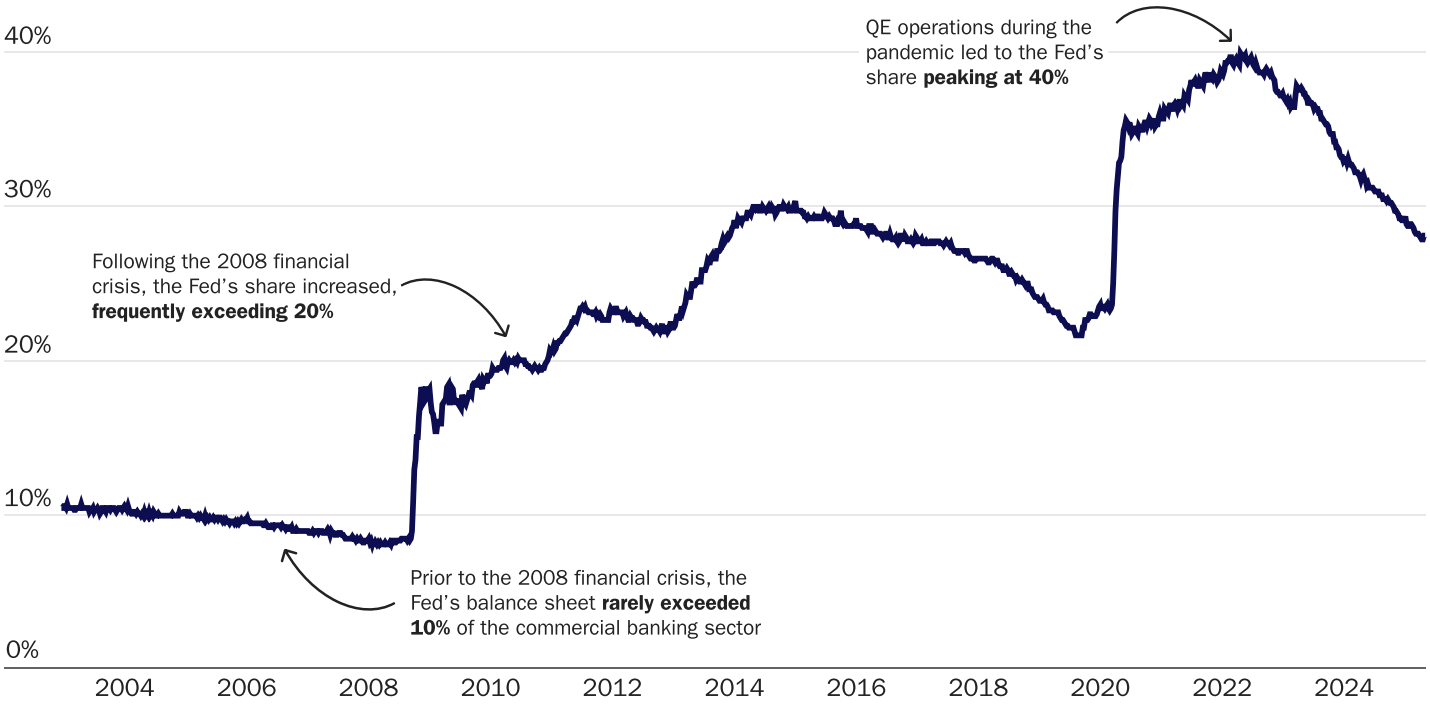
NEW TYPES OF ASSET PURCHASES ARE HARMFUL

The nature of the assets being purchased also changed post-2008, when the Fed, for the first time, expanded its

Figure 3.1

The Fed has significantly expanded its asset holdings in response to economic crises

Federal Reserve's asset holdings as a percentage of all assets held by US commercial banks



Sources: "Total Assets, All Commercial Banks," retrieved from FRED, Federal Reserve Bank of St. Louis, May 16, 2025; and "Assets: Total Assets: Total Assets: Wednesday Level," retrieved from FRED, Federal Reserve Bank of St. Louis, May 16, 2025.

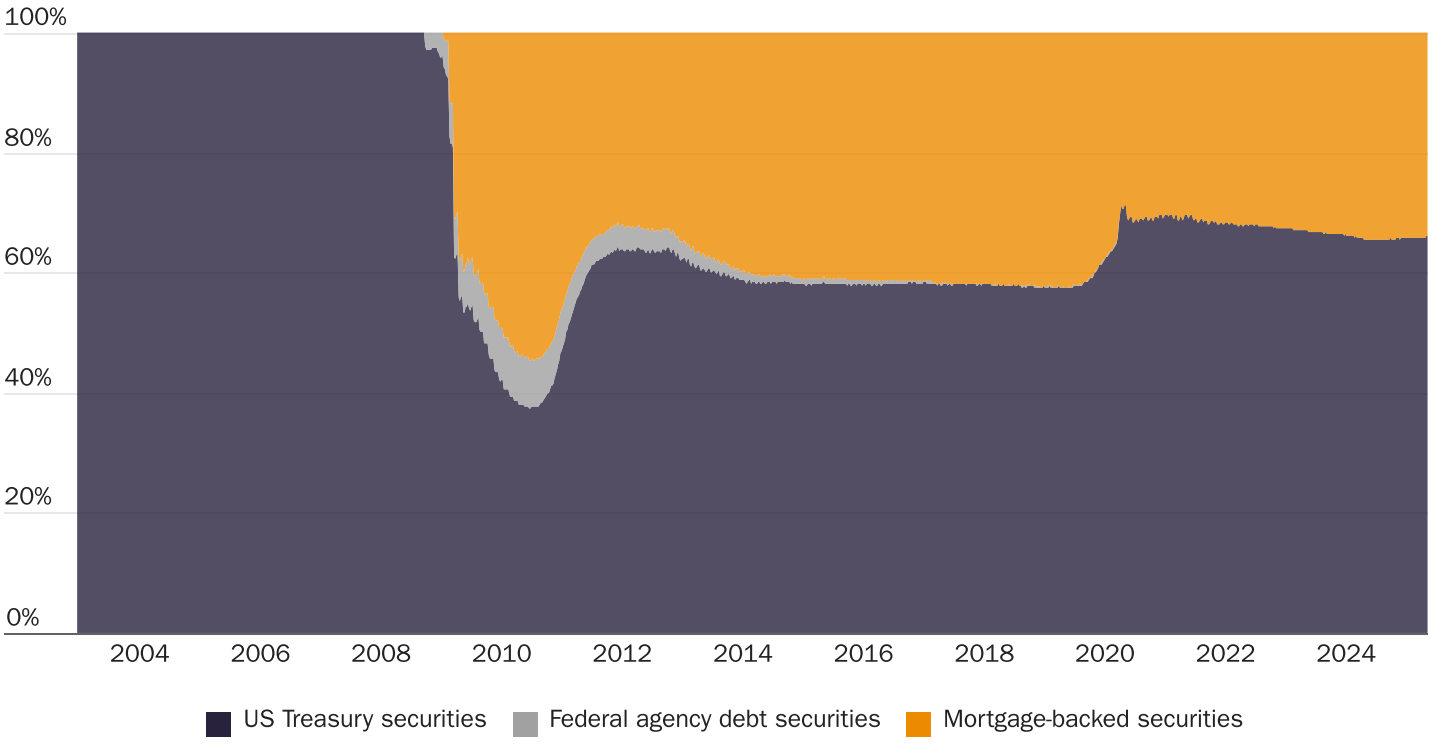
asset purchases to include a large quantity of MBS. Figure 3.2 shows the breakdown of the securities held by the Fed. As the figure shows, until 2008, the Fed purchased Treasurys, largely of a relatively short duration.[9] At their peak in 2010, MBS comprised over half the Fed's assets. Presently, one-third of its assets are MBS, with Treasury securities comprising the remaining two-thirds. Consequently, the Fed has drastically increased its footprint by preferentially allocating credit to the housing sector and distorting it away from its market-based equilibrium.[10]

The QE program's focus on long-term Treasury securities is also concerning because it exposes the Fed to heightened interest rate risk.[11] Put differently, these long-term asset purchases mean that the Fed, to a much greater extent than in the past, now borrows short while lending long. This operation exposes the Fed to financial losses when short-term rates rise, because the Fed must pay higher rates than the rates it will receive. The Fed's "borrowing" comes in the form of bank reserves and reverse repurchase agreements—both of which have associated interest payments and are very short-term liabilities. That is, the Fed's profitability rests on an upward-sloping yield curve (where long-term rates are higher than short-term rates) and it faces losses if the yield curve inverts.[12] The yield curve usually slopes upward, but this relationship is not guaranteed, as demonstrated by the downward-sloping yield curve experienced for much of the past few years. The Fed did not face interest rate risks of this kind, or the resulting financial losses, when it focused on short-term Treasurys in a low-rate environment.

Figure 3.2

The Fed drastically shifted its assets away from short-term Treasurys toward mortgage-backed securities following the 2008 financial crisis

Federal Reserve securities held outright by type, percent



Sources: "Assets: Securities Held Outright: Securities Held Outright: Wednesday Level," retrieved from FRED, Federal Reserve Bank of St. Louis; "Assets: Securities Held Outright: US Treasury Securities: Wednesday Level," retrieved from FRED, Federal Reserve Bank of St. Louis; "Assets: Securities Held Outright: Federal Agency Debt Securities: Wednesday Level," retrieved from FRED, Federal Reserve Bank of St. Louis; and "Assets: Securities Held Outright: Mortgage-Backed Securities: Wednesday Level," retrieved from FRED, Federal Reserve Bank of St. Louis.

QE ENABLES RECKLESS FISCAL SPENDING

The new abundant-reserves system divorces the Fed's monetary policy stance from the size of its 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 allow the Fed to be a pawn of the US Treasury for the simple reason that its asset purchases no longer directly threaten its price-stability mandate—the Fed's operating framework is designed to pay interest on reserves for the express purpose of preventing asset purchases from funding broader money creation. Ultimately, the Fed's current operating system increases the risk that its QE powers will be used in the funding of backdoor government spending.

Federal spending is supposed to go through the congressional appropriations process, but the Fed's new abundant-reserves regime provides a path for bypassing that process. That is, the new regime enhances the Fed's ability to fund government programs—such as a Green New Deal, energy subsidies, or an industrial development bank—independent of the appropriations process to a much greater degree than before. Federal agencies could, for example, increase their funding by selling securities to the Fed, thus making it less likely that Congress will control government spending. Because the new regime is built upon "containing" newly created reserves, the Fed would no longer be able to stave off such backdoor funding by appealing to its congressional price-stability mandate.[13]

Arguably, QE could have been an effective emergency program in some circumstances. The Fed's implementation of QE, however, has proven that such "emergency" programs are nearly impossible to contain and eliminate. Prolonged QE of this kind—it has become an all but permanent fixture at the Fed—blurs the lines between monetary and fiscal policy. Such a scenario can trigger fiscal dominance, a situation where the central bank's ability to conduct independent monetary policy is constrained by the government's fiscal position. The central bank is pressured, explicitly or implicitly, to help finance government debt. In such a regime, fiscal needs drive monetary policy, risking macro-instability and loss of central bank credibility—problems more typically inherent in politically unstable countries.[14]

FIXING THE BALANCE SHEET

When the QE program launched, it came with a commitment to restore asset holdings to pre-2008 levels.[15] This restoration has not yet happened, nor is it likely to happen soon. At the very least, the Fed should deflate its balance sheet until it is commensurate with its size relative to the private sector before the 2008 recession. This change would mitigate QE's effects on financial markets as well as return the Fed's framework to a scarce-reserves regime. This would in turn strengthen the private borrowing market for reserves once again, allowing the federal funds rate to send a correct signal of borrowing conditions. The return to the scarce-reserves framework would have the added benefit of shielding the Fed's independence from wanton government spending. Since monetary surpluses do have macroeconomic effects, particularly inflation, when reserves are scarce, Congress would no longer be able to use the Fed as a backdoor spending mechanism.

To be fair, as Figure 3.1 shows, the Fed has attempted to reduce its asset holdings during periods of economic calm. However, the Fed has little incentive to wind up the QE purchases quickly for fear of inducing tighter credit conditions. Predictably, any additional economic disturbance further slowed the Fed's pace for shrinking its balance sheet, and the temptation to implement new QE-style purchases has proven too great to resist. Consequently, the Fed should commit to not engaging in QE, even if there is external pressure to do so from financial market participants or elected officials.

The Fed's operations in the wake of the 2008 financial crisis gave rise to an experimental policy framework that replaced traditional market activity with bureaucratically administered interest rates. To shrink the Fed's currently outsized footprint, thus restoring the market forces that the Fed has displaced, the Fed should shrink its balance sheet and end these experimental programs. To ensure

that the Fed can no longer implement these types of lending programs in the future, Congress should restrict the Fed to purchasing only short-term US Treasury bonds. Additionally, Congress should limit the size of the Fed's balance sheet. For example, Congress could cap the Fed's total assets at no more than 10 percent of the commercial banking sector's total assets, the approximate share held by the Fed prior to the 2008 financial crisis.[16] These restrictions would make it harder for Congress to use the Fed for backdoor fiscal expenditures, and for the Fed to allocate credit beyond the banking sector.

CONCLUSION

The Federal Reserve has vastly expanded its footprint in financial markets through massive asset purchases. The size of the Fed's balance sheet raises serious concerns about fiscal independence and financial stability. To maintain a clear demarcation between monetary and fiscal policy, as well as minimize the Fed's footprint on financial markets, the Fed must trade only short-term US Treasury securities and revert to its pre-2008 policy framework. Congress should also limit the size of the Fed's total assets relative to the size of the financial sector or outstanding federal debt.

NOTES

1. This section addresses the economic concerns caused by the assets side of the Fed's balance sheet. Section 4 addresses the equivalent interest payment concerns stemming from the Fed's liabilities. Of course, assets and liabilities are just two sides of the same coin. Any meaningful policy change would need reform on each side of the Fed's balance sheet.

2. Agency MBS refers to MBS issued by Fannie Mae and Freddie Mac (both government-sponsored enterprises), or Ginnie Mae (a wholly owned US government corporation within the Department of Housing and Urban Development).

3. The idea is that the Fed's purchases of longer-term securities will cause a portfolio balance effect, where investors tend to rebalance their portfolio away from the (safer) Treasury securities that the Fed's purchases made scarcer to other (riskier) long-term assets. In theory, these riskier assets would now be purchased at higher prices, thus placing downward pressure on long-term interest rates.

4. For a critical appraisal of QE's effectiveness, see Daniel L. Thornton, "Requiem for QE," Cato Institute Policy Analysis no. 783, November 17, 2015.

5. Gara Afonso et al., "Who's Borrowing and Lending in the Fed Funds Market Today?," *Liberty Street Economics* (blog), Federal Reserve Bank of New York, October 10, 2023.

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

7. Esteban P. Caldentey, "Quantitative Easing (QE), Changes in Global Liquidity, and Financial Instability," *International Journal of Political Economy* 46, no. 2/3 (Summer–Fall 2017): 91–112.

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

9. In this context, "relatively short" refers to Treasury securities with a 5-year maturity or less. Until 2008, roughly 80 percent of the Fed's Treasury holdings were of such types, and the shares of under 90 days, 90-day to 1-year, and 1-year to 5-year Treasury securities were relatively similar and constant. Since the 2008 crisis, the Fed's holdings of Treasury bonds with a maturity of 1 year or less have shrunk below 20 percent of its assets. See Eric Milstein et al., "What Does the Federal Reserve Mean When It Talks About Tapering?," commentary, Brookings Institution, updated January 27, 2022.

10. These purchases also served as off-budget support (arguably, a bailout) of Fannie Mae and Freddie Mac, the two housing-finance giants that have remained in conservatorship since 2008, as well as financial institutions holding their securities. See Norbert Michel, "The GSE Experiment Has Failed—Congress Should End It," Cato Institute Briefing Paper no. 180, October 14, 2024; and Steven Horwitz, "An Introduction to US Monetary Policy," Mercatus Center at George Mason University, April 2, 2013.

11. Peter N. Ireland, "Interest on Reserves: History and Rationale, Complications and Risks," *Cato Journal* 39, no. 2 (Spring/Summer 2019).

12. The yield curve is a chart showing the relationship

between interest rates (bond yields) and the maturity lengths of bonds, typically US Treasurys. A normal curve slopes upward, indicating that investors need higher yields for longer maturities, while an inverted curve—where short-term rates exceed long-term rates—can signal expectations of economic slowdown or recession.

13. George Selgin, *The Menace of Fiscal QE* (Cato Institute, 2020). The Fed could even expand its deferred asset and remit funds directly to the Treasury without the ability to fall back on its price-stability mandate. See also Norbert Michel, "Treasury's $1 Trillion Coin and the Fed's Magic Asset," *Forbes*, January 26, 2023.

14. Eric Leeper, "Fiscal Dominance: How Worried Should We Be?," Mercatus Center at George Mason University, April 3, 2023.

15. Ben S. Bernanke, "The Federal Reserve's Balance Sheet: An Update," speech, Federal Reserve Board Conference on Key Developments in Monetary Policy, October 8, 2009, Washington, DC, Board of Governors of the Federal Reserve System.

16. Alternatively, Congress could cap the Fed's total assets at 10 percent of the share of total outstanding federal debt, the share it approximately was before 2008.

Section 4.
Ending the Interest on Reserves Program

Since its implementation in 2008, the Federal Reserve's interest on reserves (IOR) program has been a controversial inclusion to US monetary policy. This program received little attention from critics prior to the COVID-19 crisis because the US remained in a period of historically low interest rates, ensuring that the Fed's interest payments were relatively small. However, because interest rates rose in response to the post-pandemic surge in inflation, the Fed has disbursed billions in risk-free government payments to large banks. Significant attention has been paid to the assets side of the Fed's balance sheet, but its liabilities are now cause for equal concern.[1]

The Fed has mostly waved away concerns over IOR losses, but the truth is that the IOR program is economically costly, endangers the Fed's price stability mandate, and amounts to government support for the financial sector. For instance, the Fed's audited financial statements for 2023 and 2024 show that the Fed suffered billions of dollars of operating losses due to the large amounts of interest it pays on bank reserves. Losses on interest payments make it costly for the Fed to fight inflation, threatening its price stability mandate. These data should worry even the most ardent of Fed defenders. It is time to put an end to the interest on reserves program and require the Fed to conduct rules-based monetary policy that disrupts individuals' and firms' economic decisions as little as possible.

INTEREST ON RESERVES EXPLAINED

The Fed drastically changed its operating framework following the financial crisis of 2008. At the time, most of the attention fell on the Fed's quantitative easing program. The Fed's asset purchases during the crisis also prompted it to begin paying commercial banks IOR deposited at the Fed.

To be fair, there are economically justifiable reasons to pay IOR to banks. In a fiat money regime, these reserves can be created at a zero marginal cost. Consequently, for economic efficiency, the opportunity cost to banks for holding these reserves should be zero as well. This outcome could be achieved by paying banks interest commensurate with the returns they could make on low-risk short-term assets. Despite its original intent, the Fed's IOR program has morphed beyond simply covering banks' opportunity costs for holding reserves. It now threatens the Fed's core functions and has made the Fed overly entrenched in financial markets.[2]

After it created enormous amounts of reserves during the 2008 financial crisis, the Fed began relying heavily on the IOR framework because it gave the Fed better control over its ultimate policy rate—the federal funds rate (FFR). The FFR is the overnight rate at which banks lend reserves to each other. Since the FFR is the cost for banks to acquire reserves, the FFR in turn can affect the rate at which banks are willing to lend money to their customers. Thus, by influencing the FFR, the Fed can ease or tighten financial conditions, allowing it to influence the real economy, at least in theory.

The Fed's flooding of the banking system with reserves in the aftermath of the 2008 crisis necessitated reliance on the IOR program because the Fed lacked a way to dissuade banks from using those reserves to create new loans and deposits. In this type of "abundant reserve" framework, changing the *quantity* of these reserves no longer affects the FFR, so normal open market operations—the buying and selling of Treasury securities—became an ineffective tool for implementing monetary policy. However, the IOR should still be effective at changing the interbank lending rate because banks generally will not lend to other banks at rates lower than the risk-free rate at which they can collect interest from the Fed. Consequently, changing the IOR rate to affect the cost of holding reserves is now the Fed's main

instrument for changing the FFR and thereby conducting monetary policy.[3]

THE FED LOST BILLIONS THROUGH INTEREST PAYMENTS

For most of the period since the Fed began paying IOR, interest rates were at an all-time low—very close to their zero lower bound. As a result, the Fed's decision to pay IOR made little difference in practice because interest payments were small. However, as careful observers had warned for a decade, the Fed's IOR policy spells disaster in a world with high interest rates—the world we live in now.[4]

Indications of the harmful effects of IOR policies have been present since the COVID-19 pandemic. To accommodate its pandemic-related large-scale asset purchases, the Fed drastically increased banks' reserves and paid interest on all these newly minted reserves. Consequently, banks had little incentive to borrow from each other or lend funds to the public, resulting in significantly lowered activity in the federal funds market.[5] In turn, this inactivity led to a dampening of the effects of the FFR on other borrowing costs.[6] At the same time, inflation went far beyond the Fed's 2 percent target, ultimately requiring the Fed to severely tighten its monetary policy stance. By late 2023, the Fed had increased the FFR by raising the IOR rate to 5.40 percent. The consequence of this post-pandemic policymaking was a dramatic increase in both the principal and interest rate of the Fed's liabilities.

As Figure 4.1 shows, the Fed's interest payments have increased exponentially as a result. (All dollar values have been adjusted for inflation by converting them to their equivalent in 2024 dollars.) Moreover, the rate of increase in interest expenses mirrors the rate of increase in the IOR.

It was no surprise, then, that the Fed reported operating losses of $111 billion in 2023, driven largely by interest expenditures. The Fed followed suit in 2024 with a $77.6 billion loss, again mostly from interest payments. As Figure 4.2 shows, these were the first recorded losses since 2008 and the only losses on record since the data became available. Such losses are especially likely if increased IOR rates are not offset by similar increases to the rates of return on the Fed's assets. As recent Cato CMFA research has shown, as the Fed's losses have mounted, several key borrowing rates in the market have become less correlated with the Fed's policy rate.[7]

FED INDIFFERENCE IS UNWARRANTED

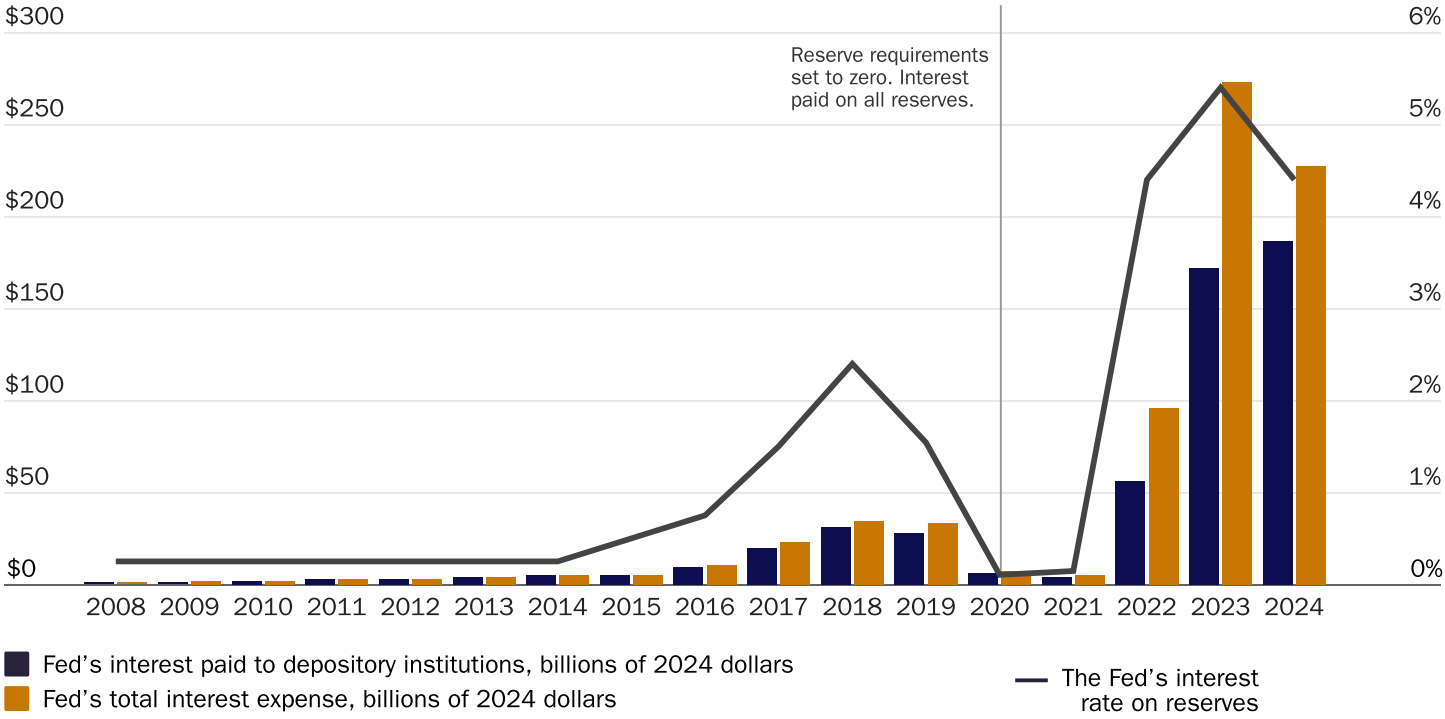
Fed officials are largely unconcerned about losses from interest payments. The losses are simply marked down as an IOU called a "deferred asset," essentially allowing the Fed to monetize its own debt with a promise to use future profits to offset these write-offs. According to a press release: "A deferred asset has no implications for the Federal Reserve's conduct of monetary policy or its ability to meet its financial obligations."[8] This nonchalance is dangerous and unwarranted. It is technically true that the Fed can continue to exhibit losses, as it does not require operational profitability like a private financial firm does. (Indeed, if the Fed were a private bank, any one year of such losses may have been enough to shutter its business.) But, while the Fed is not a private bank and it can sustain these losses for a longer period, it is not true that there are no causes for concern beyond profitability. There are three major reasons for concern over the IOR framework and resulting losses.

First, the economic costs of these losses are high. Assuming that marking off future profits to account for current losses has no economic effects is economically unsound. Balancing books via accounting rules ignores opportunity costs. That is, accounting rules do not quantify the gains that could have been achieved from using funds for alternative purposes, such as paying down federal debt. In fact, for decades profits from the Fed's operations have been remitted to the Treasury and gone toward paying off the federal government's massive fiscal deficit. Now, as a result of higher interest rates, future Fed profits will be funneled toward canceling deferred assets instead of helping with the government's borrowing bill. Instead, the Treasury will have to issue even more debt in this amount, which will lead to an even greater fiscal imbalance. In other words, these higher interest payments will place a higher burden on future taxpayers even though the Fed's accounting costs appear to be zero.

Second, the IOR framework creates a conflict of interest with the Fed's mandate to stabilize prices. As

Figure 4.1

Pandemic-era Fed policy of increasing interest paid on reserves sparked a surge in interest payments



Sources: Federal Reserve Banks Combined Financial Statements (2008–2024); and US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in US. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis, May 16, 2025.

discussed, the Fed's primary mechanism for achieving stable prices is to influence the federal funds rate by altering the IOR. Specifically, to combat inflation, the Fed tightens its monetary policy stance by raising the IOR.

However, as shown in Figures 4.1 and 4.2, increases in the IOR result in large interest expenses and consequently losses for the Fed. Despite what they may claim publicly, Fed officials cannot continue to exhibit losses on their financial statements indefinitely. Realistically, at some point, large financial losses would undermine the Fed's ability to support the banking sector and the US government's ability to issue new debt, just as it would in politically unstable countries. Moreover, losses create a potential complication for monetary policy because the Fed must increase the IOR to combat inflation even though every increase in the IOR rate increases the Fed's potential losses.[9] This inherent conflict only makes the Fed's fight against inflation more difficult.

Third, the IOR system facilitates government support for the private financial sector. At its core, the IOR policy is a government subsidy to large financial institutions. Banks now have their own risk-free savings accounts, giving them returns that are hundreds of basis points higher than what regular consumers receive on their own deposits at the very same institutions. If that isn't bad enough, the billions that banks receive in interest payments have reduced their incentive to lend in the private market, reducing the cash available to regular Americans to borrow while flooding the banking system with trillions in reserves. In an environment where financial institutions serve as the boogeyman for politicians on both sides of the political aisle, it seems only a matter of time before at least one political party threatens the Fed's ability to conduct policy using IOR.

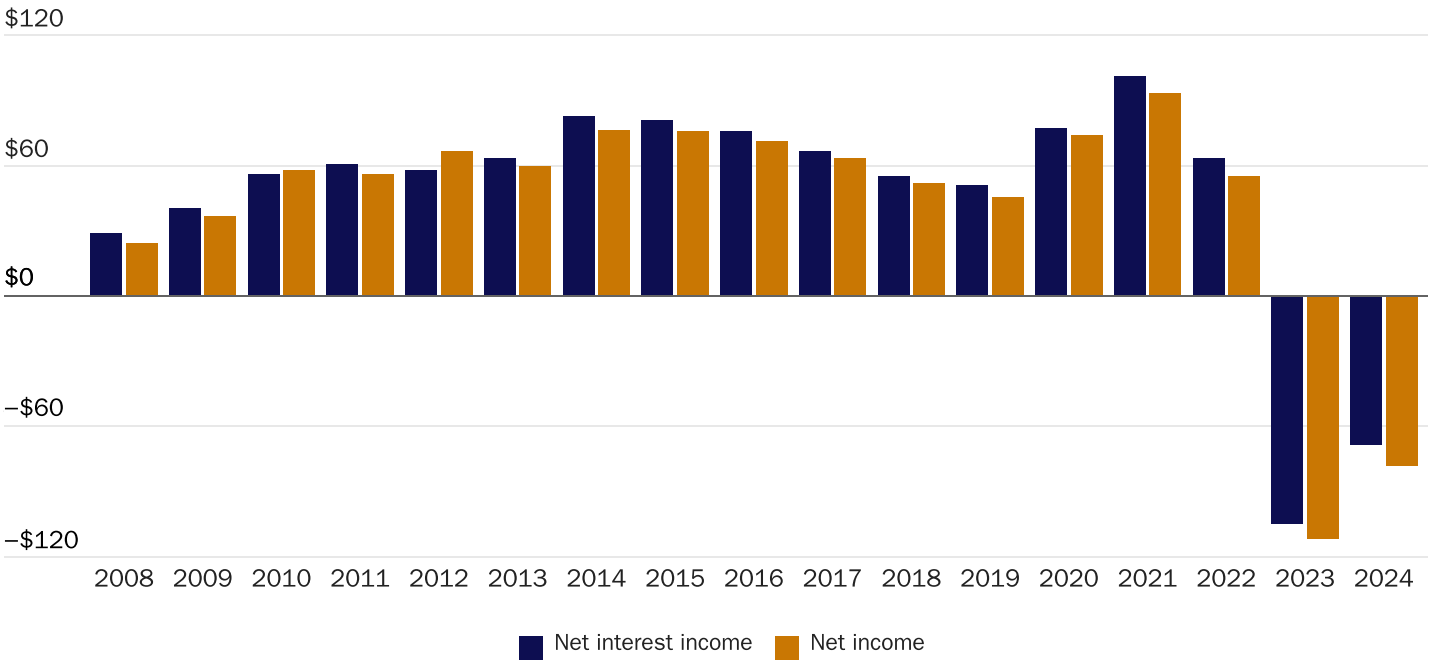
CONCLUSION

The Fed has lost billions of dollars by paying interest to large banks on their reserves. This policy is economically costly, threatens the Fed's mandate to stabilize prices, and is unfair to everyday Americans. It is imperative that the

Figure 4.2

Fed's interest on reserves policy coupled with higher rates led to unprecedented operating losses

Federal Reserve operating income, billions of 2024 dollars



Sources: Federal Reserve Banks Combined Financial Statements (2008–2024); and US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in US. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis, May 16, 2025.

IOR policy is repealed and the Fed's operating framework is returned to its pre-2008 system. Along with other restrictions on the Fed's ability to purchase securities, these policy changes would make it harder for Congress to use the Fed for backdoor fiscal expenditures and for the Fed to serve as an instrument of credit allocation.

NOTES

1. Of course, improved monetary policy requires reform to the Fed's entire balance sheet in conjunction. We address the assets and liabilities sides of the balance sheet in separate briefs for simplicity and clarity. For more details on the assets side of the Fed's balance sheet, see section 3 of this publication: Norbert Michel and Jai Kedia, "Restoring Sensible Asset Purchases," Reforming the Federal Reserve, Cato Institute.

2. For more on the rationale behind paying interest on reserves, see Peter Ireland, "Interest on Reserves: History and Rationale, Complications and Risks," *Cato Journal* 39, no. 2 (Spring/Summer 2019).

3. For a detailed explanation of how monetary policy works, see section 2 of this publication: Norbert J. Michel and Jai Kedia, "Enforcing Rules-Based Monetary Policy," Reforming the Federal Reserve, Cato Institute.

4. Norbert J. Michel, "Risks from Fed's Interest on Reserves Threaten More Than Monetary Policy," *Forbes*, April 6, 2015.

5. As a result of the policy framework switch, daily trading volume in the Fed funds market fell from its pre-2008 level of $150–$175 billion to just $60–$80 billion in the mid-2010s. Gara Afonso et al., "Who's Borrowing and Lending in the Fed Funds Market Today?," *Liberty Street Economics* (blog), Federal Reserve Bank of New York, October 10, 2023.

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

October 24, 2024.

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

8. "Federal Reserve Board Announces Preliminary Financial Information for the Federal Reserve Banks' Income and Expenses in 2023," news release, Federal Reserve, January 12, 2024.

9. There is already an ever-present political desire to keep rates low, and the Fed did keep rates too low for too long post-pandemic. Jai Kedia, "Pandemic Policymaking Warrants Narrower Fed Mandate," *Cato at Liberty* (blog), Cato Institute, December 6, 2023.

Section 5.
Preventing Fiscal Dominance

Almost all early central banks were created to help finance government expenditures—that is, they were designed to facilitate government borrowing, often through direct purchases of government debt.[1] Over time, developed countries have moved away from such arrangements, and central banks have taken on broader macroeconomic responsibilities while maintaining a degree of independence from the government's borrowing and spending.

Still, this independence does not constitute a full separation between monetary policy and fiscal policy because all monetary policy actions have some fiscal consequences.[2] Moreover, the Fed's monetary policy does not solely determine the economy's rate of inflation, which is determined by, among other factors, interactions between both fiscal and monetary policy decisions. Policymakers should actively analyze these interactions rather than relying only on the Fed to keep prices stable.

Despite these interactions, monetary policy and the task of keeping inflation low and stable are under the mandated purview of the Federal Reserve. Under normal circumstances, the Fed does play the dominant role in managing price levels, but ultimately, maintaining stable inflation requires the central bank to work in conjunction with a responsible fiscal agent that facilitates good monetary policy. But an irresponsible fiscal agent that runs persistent deficits and does not sustainably manage the national budget can derail monetary policy. If this happens, the central bank can be forced to choose between keeping inflation low and preventing default on the national debt. Of course, in most such situations, the monetary authority usually abandons its price stability goals and instead uses monetary tools to lower the government's interest payments.[3] This situation, known as fiscal dominance, is liable to result in high inflation.

As we discussed in a previous paper in this series, the Fed's operating framework now makes it easier to exploit the central bank through backdoor fiscal operations that avoid the normal appropriations process. This new framework makes the threat of fiscal dominance more real than ever. Congress can, and should, remedy this situation by requiring the Fed to abandon its current operating framework and follow rules-based monetary policy. In the absence of congressional action, the Fed can shield the economy from fiscal dominance by simply implementing good reform policies on its own: These include shrinking its balance sheet and following a transparent policy rule.

FISCAL DOMINANCE EXPLAINED

Put simply, fiscal dominance is a macroeconomic condition where fiscal policy (i.e., government spending, borrowing, and taxation) effectively dictates a country's monetary policy rather than the other way around. It can arise when there is a coordination failure between a country's monetary and fiscal agents, including instances of surprise fiscal expenditures that unexpectedly increase deficits and debt well beyond their existing trends.

To properly coordinate, the central bank must be active, and the fiscal agent must be passive. A central bank is active when it adjusts the target for the policy rate (in the US, this is the federal funds rate) to keep inflation low and stable; it is passive when it uses the policy rate to ensure that interest payments on outstanding government debt remain low. A fiscal agent is passive when it spends sustainably; it is active when it spends unsustainably with no clear aim of eventually balancing the budget.

There are four possible combinations of monetary and fiscal interactions.[4] Two such outcomes are when both agents are active or both are passive. In such cases, economic theory

predicts that the price level will be indeterminate—a situation where inflation could become unstable and unpredictable. These outcomes are unlikely to occur in advanced economies such as the US, where inflation expectations remain anchored, so the public usually ignores them.[5]

The scenario that most people are familiar with historically, though, is when the central bank is active and the fiscal agent is passive. Most economists agree that the US was under such a system from the mid-1980s through at least the financial crisis of 2008—a period characterized by low and stable inflation. A situation with a passive central bank and an active fiscal agent is known as fiscal dominance.[6] Unlike the indeterminate cases, fiscal dominance can and does occur in advanced economies, especially in today's political climate, where government deficits are unsustainably high.[7]

In theory, fiscal dominance could mirror monetary dominance and yield stable outcomes if fiscal authorities are credibly committed to discipline. But in practice, political incentives make this sort of commitment highly unlikely, increasing the risk of higher inflation.[8] Several episodes from economic history demonstrate that fiscal-dominant regimes resort to the kind of policies that favor political expedience. These examples include those Western European countries that experienced hyperinflation in the interwar period and modern cases such as Argentina and Turkey.[9] The lesson is straightforward: Without fiscal discipline, the Fed cannot achieve low and stable inflation. In today's high-deficit environment, the US risks slipping toward fiscal dominance, where monetary policy becomes hostage to fiscal policy, thus risking higher inflation.

ASSERTING MONETARY DOMINANCE

Understandably, most policy prescriptions that attempt to shield the Fed from fiscal dominance usually call for the fiscal agent to spend judiciously. That is a worthwhile goal, but the Fed can take steps to shield itself from fiscal dominance. In fact, the prescriptions offered in prior chapters of this series, meant primarily to improve overall monetary policy performance, can also help the US stay away from a fiscal-dominant regime. Given Congress's penchant for increasing government expenditures, it seems wise for the central bank to act as a check on fiscal dominance.

The interaction between the monetary and fiscal authorities requires one agent to cede and relinquish control, resorting to a passive strategy to avoid the worse result, where both agents are active. The Fed must strongly signal to the fiscal authority its intent to be the active participant (proverbially tying its hands to the wheel, as one would in a game of chicken), forcing the fiscal agent to resort to its passive strategy. To credibly provide such a signal, the Fed could adopt a rules-based monetary policy framework.[10]

Under such a framework, the Fed would publish an arithmetic rule that sets its target for the federal funds rate based on current values of macroeconomic indicators, such as inflation, output growth, unemployment, and others. The Fed could update the rule at moderate intervals, but importantly, once the Fed publishes the rule, it must follow it. With a properly structured rule in place, an irresponsible fiscal agent cannot be bailed out by an accommodative monetary agent. This would force the fiscal agent to exercise restraint.

But self-imposed rules-based policy from the Fed cannot alone fix this problem because the central bank can always deviate from those rules. Congress must act as well. A legislative directive requiring the Fed to follow the rules it has outlined would increase the likelihood of its adherence.

In conjunction with following its rules-based policy enforced by Congress, the Fed must also shrink its balance sheet and restore monetary policy to its pre-2008 operating framework—that is, reverting from the current abundant-reserves system back to a scarce-reserves system.[11] This fix to the Fed's assets column must be matched with a corresponding fix to its liabilities by ending the interest on reserves program.[12] Abundant banking reserves, created by multiple rounds of quantitative easing, have led to an economic environment in which further asset purchases largely do not affect the federal funds rate.

Under the current operating framework, the Fed can keep buying assets with little fear of creating runaway inflation because it can pay financial institutions to sit on reserves. For instance, it can buy more US Treasurys

to provide funding for more government programs. Theoretically, at least, paying higher rates of interest on these reserves means that the Fed's operations will increase aggregate bank reserves without generating more inflation from those reserves.

Consequently, Congress can use the Fed as a backdoor spending mechanism to fund its activities without going through the necessary appropriations process. This makes government borrowing and spending less sustainable and fiscal dominance more likely. A return to a scarce-reserves system would restore the link between monetary operations and market-determined interest rates, reducing the Fed's role as a fiscal enabler.

CONCLUSION

As the US government recklessly spends without any consideration for a sustainable debt trajectory, fiscal dominance becomes increasingly likely. If fiscal dominance occurs, the central bank must set aside its mandate to stabilize inflation and instead focus on keeping the interest payments on the federal debt low. Fiscal dominance usually results in high inflation, as we have seen several times in history. To prevent fiscal dominance, the Fed should adopt a rules-based monetary policy and continue reducing its balance sheet to revert the financial system back to a scarce-reserves regime. This will improve the Fed's performance as well as prevent the fiscal agent from subverting monetary policy.

NOTES

1. Michael D. Bordo, "A Brief History of Central Banks," Federal Reserve Bank of Cleveland, December 2007; and Kurt Schuler, "The World History of Free Banking: An Overview," in *The Experience of Free Banking*, 2nd ed., ed. Kevin Dowd (Institute of Economic Affairs, 2023), pp. 36–42.

2. At the very least, expansionary monetary policy can lead to inflation, which can affect the real cost of government debt. Christopher A. Sims, "Luncheon Address: Fiscal Policy, Monetary Policy and Central Bank Independence," speech, Jackson Hole Economic Policy Symposium, Federal Reserve Bank of Kansas City, August 26, 2016, Jackson Hole, WY.

3. Donna Faye E. Bajaro et al., "Monetary Policy Under Fiscal Stress: A Forward-Looking Analysis of Fiscal Dominance," *Journal of Macroeconomics* 86 (December 2025), published ahead of print.

4. Of course, these are the possibilities in the present state of the world, where a central bank is tasked with achieving specific desirable macroeconomic outcomes. Within such a world, the ideal outcome is a monetary-dominant regime. This should not be construed to mean that this outcome is the first-best one altogether—the truly best outcome would likely be achieved through privately supplied money with no central bank involvement at all.

5. In the case of indeterminacy, there are multiple possibilities for inflation, including both stable and unstable outcomes. Market participants' beliefs about the economy ultimately dictate which state the economy settles into. In countries like the US, strong inflation anchors and institutional trust generally lead to stable outcomes even under indeterminacy. But with enough erosion of trust, active/active and passive/passive cases in the US could lead to a volatile economy as it has in other countries, such as Argentina or Turkey.

6. Eric M. Leeper, "Equilibria Under 'Active' and 'Passive' Monetary and Fiscal Policies," *Journal of Monetary Economics* 27, no. 1 (February 1991): 129–47; and Neil Wallace and Thomas J. Sargent, "Some Unpleasant Monetarist Arithmetic," Federal Reserve Bank of Minneapolis *Quarterly Review* 5, no. 3 (Fall 1981): 1–17.

7. For examples, see Eric M. Leeper, "Fiscal Dominance: How Worried Should We Be?," Mercatus Center at George Mason University, March 2023.

8. Romina Boccia and Dominik Lett, "The Threat of Fiscal Dominance: Will the US Resort to Money-Printing to Finance the Rising Debt Challenge?," *Cato at Liberty* (blog), Cato Institute, April 4, 2024.

9. In a famous essay, Thomas Sargent shows that the hyperinflation in Western European countries only ended after the establishment of independent central banks that were legally required to refuse their governments' requests for unsecured debt. Since the fiscal agents could only secure quality financing by showing strict adherence to a sustainable path for their deficits, their economies switched from

fiscal-dominant to monetary-dominant regimes, and price levels stabilized. Thomas J. Sargent, "The Ends of Four Big Inflations," in *Inflation: Causes and Effects*, ed. Robert E. Hall (University of Chicago Press, January 1982), pp. 41–98.

10. See section 2 of this publication for more on rules-based monetary policy: Norbert Michel and Jai Kedia, "Enforcing Rules-Based Monetary Policy," Reforming the Federal Reserve, Cato Institute.

11. See section 3 of this publication for more on the Fed's asset purchases: Norbert Michel and Jai Kedia, "Restoring Sensible Asset Purchases," Reforming the Federal Reserve, Cato Institute.

12. See section 4 of this publication for more on interest on reserves: Norbert Michel and Jai Kedia, "Ending the Interest on Reserves Program," Reforming the Federal Reserve, Cato Institute.

Section 6.
Responsible Last Resort Lending

One role that Congress gave to the Federal Reserve in 1913 was that of "lender of last resort" (LLR). As the name suggests, this role means that the Fed is supposed to provide credit when funds are not available from any other source. The classic LLR prescription for a central bank, developed over the century prior to the Fed's creation, dictates that the Fed should ensure the system-wide flow of credit after an economic shock by offering loans on a widespread basis at a "high" rate of interest. According to this prescription, if the central bank responds "promptly and vigorously," its LLR actions would be temporary and therefore not interfere with its long-run monetary policy objectives. Notably, the classic prescription does not call for bolstering financially unsound firms or acting preemptively to prevent future shocks.[1]

Overall, the Fed has failed to adhere to the classic LLR prescription. Throughout its history, the Fed has repeatedly lent to financially troubled firms, thus jeopardizing the independence of its monetary policy decisions and putting taxpayers at risk. During its early years, the Fed likely worsened the Great Depression because it failed to adequately fulfill its LLR role by ensuring the system-wide flow of liquidity. During the 2008 financial crisis, the Fed facilitated bailouts to financially weak firms by invoking its so-called emergency lending authority. During the COVID-19 pandemic, the Fed created many temporary lending facilities that followed the classic LLR prescription. However, the Fed also created at least one lending facility that could have been used to lend directly to financially troubled private businesses.[2]

Congress could easily avoid these problems by prohibiting the Fed from making these types of loans. Indeed, as Jeff Lacker, former president of the Richmond Fed, has explained, "history and experience suggest that the Fed's balance sheet activities should be restricted to the conduct of monetary policy."[3] Regardless, there is no clear economic rationale for the Fed to provide direct loans to private firms. Given the sophistication of modern financial markets, there is now less reason to allow the central bank to serve as an LLR than there was in 1913.

OVERVIEW OF THE FED'S LLR HISTORY

The Fed has used several different methods throughout its history to fulfill its LLR function.[4] The main method has been through the normal open market operations that the Fed uses to manage the monetary base. Through these operations, the Fed has regularly provided liquidity to the entire market by purchasing Treasury securities, and these operations can be temporarily expanded in the event of a crisis.

Whether on a permanent or temporary basis, open market purchases add reserves to the banking system, thus bolstering the federal funds market (a private market where banks lend reserves to each other) with additional funds. This injection of reserves tends to lower the rate that banks charge each other to lend in this market (the federal funds rate), thus providing banks with easier access to a highly liquid source of funds. Therefore, the federal funds market provides a way for the Fed to fulfill its LLR function by adding system-wide liquidity and allowing private firms—instead of the central bank—to allocate credit to specific institutions.

In several specific crises, the Fed successfully expanded its open market purchases to carry out its LLR function. For instance, after the 1987 stock market crash, prior to the Y2K computer scare, and in the wake of the 9/11 terrorist attacks, the Fed temporarily expanded its normal open market Treasury purchases. In these cases, the Fed also made clear public announcements that it was doing so specifically to provide temporary liquidity.

At many points in history, though, the Fed has used alternative methods to fulfill its LLR function that failed to adhere to the classic LLR prescription. For starters, the Fed lends directly to banks (depository institutions) through its discount window, a method of lending that was originally envisioned as the main tool of monetary policy. Initially, each of the 12 Federal Reserve Banks had an actual window in its lobby to make these loans to member banks. The term now refers more generally to the regular provision of credit, as opposed to emergency credit, by the central bank to individual depository institutions on predefined terms. The Fed's discount window lending has long been the source of controversy with respect to proper LLR operations.

In its earlier years, the Fed broke with the classic LLR tradition by lending continually—often to failing banks—through the discount window rather than only on a temporary basis.[5] One of the first troublesome expansions of discount window lending came in 1932, when the Glass–Steagall Act added Section 13(3) to the Federal Reserve Act. This change opened the Fed's discount window to nonbanks—individuals, partnerships, and corporations—in "unusual and exigent circumstances."[6] Another major change was instituted when the 1934 Industrial Advances Act was approved and added to the Federal Reserve Act as Section 13(b). This section authorized the district banks to provide working capital loans directly to industrial and commercial businesses for periods of up to five years, without any limitations on the type of collateral. By 1939, the district banks had provided nearly $200 million in working capital loans to nearly 3,000 applicants. These loans did not fit the classic LLR prescription because they provided firms with a substitute for private capital.

In 1946, the Federal Reserve Board began lobbying Congress to eliminate its own Section 13(b) authority, and Congress finally repealed Section 13(b) with the Small Business Investment Act of 1958. During the congressional debate on the 1958 bill, Fed Chairman William McChesney Martin Jr. testified to Congress that the Fed should not provide capital to institutions and that its primary objective should be "guiding monetary and credit policy."[7] Roughly 20 years later, the Fed appropriately refused to open the discount window when the Nixon administration asked the New York Fed to provide loans to financially troubled Penn Central Railroad.[8]

That success was short-lived, though, and the Fed immediately followed that refusal with what monetary scholar Anna Schwartz called "the 'too big to fail' doctrine in embryo."[9] Ostensibly worried about fallout from Penn Central's bankruptcy and commercial paper default, the Fed announced that it would provide discount window lending to banks to assist businesses that could not issue new commercial paper. In this case, the Fed went to great lengths to prevent a potential future shock from a non-financial firm's failure. Perhaps worse, the phrase "too big to fail" came into widespread use after the Fed helped facilitate the 1984 bailout of Continental Illinois National Bank.[10]

During the 2008 financial crisis, the Fed allocated credit directly to several firms and created more than a dozen special lending programs by invoking its emergency authority under Section 13(3) of the Federal Reserve Act. Two of the most widely publicized examples of direct loans were the Fed's $13 billion loan to Bear Stearns and a $30 billion loan to facilitate JPMorganChase's acquisition of Bear Stearns. The Government Accountability Office estimates that from December 1, 2007, through July 21, 2010, the Fed lent financial firms more than $16 trillion (roughly equivalent to the United States' annual GDP in 2009) through its broad-based emergency lending programs, and Bloomberg Markets estimates that the Fed charged $13 billion below market rates for its emergency loans from 2007 to 2010.[11]

In practical terms, the Fed's LLR function must be operationalized through legislation and the provisioning of credit. In the 1930s, Congress expanded the Fed's lending authority in what may have seemed a restrictive manner, allowing it to lend only in "unusual and exigent circumstances." Of course, these terms require at least some subjective interpretation, which led, in part, to controversies surrounding the 2008 financial crisis lending programs.[12]

Perhaps less appreciated, though, is how the Fed's lending authority fits in with other operational changes the Fed has undergone. For instance, in the wake of the 2008 crisis, the Fed altered its operating system such that it depends on an abundant reserve system and the payment of interest

on those reserves. This system effectively divorces the Fed's monetary policy stance from the size of its balance sheet, potentially allowing the Fed to expand its footprint and facilitate backdoor spending that usurps both the congressional appropriations process and private financial markets.[13] Reforming the Fed's LLR function is even more important given these operational changes.

FLEXIBLE OPEN MARKET OPERATIONS AS A FIX FOR LLR

When the Fed was created in 1913, the practical implementation of LLR policy was tied to maintaining the gold standard, an international system that has not existed since the 1930s. In a modern fiat money system, however, central banks are no longer constrained by the need to protect gold reserves or to preserve the convertibility of the nation's currency to gold at a fixed exchange rate. Central banks now have one primary duty: supplying the most liquid form of the nation's money supply (cash and bank reserves) in quantities sufficient to meet certain macroeconomic targets.

As monetary scholar George Selgin has pointed out, experience suggests that the conventional dichotomy of "emergency" and "ordinary" central-bank liquidity provision has outlived its usefulness.[14] Put differently, a central bank can now easily provide both emergency and ordinary liquidity provision more efficiently than in the past. In particular, the fact that central banks' main duty is to adequately and efficiently supply their economies' most liquid assets calls for assigning as large a role as possible to market prices for allocating new central-bank credits among rival applicants.

To best accomplish this goal, the Fed could implement a single auction mechanism for flexible open market operations, like the system created by the Bank of England. The idea is to provide auctions for both ordinary open market operations and predefined emergency open market operations from the same lending facility so that all eligible counterparties can compete on equal terms for central-bank liquidity. Under this arrangement, the central bank, once having set the terms of the auction, would have no other duty to perform save that of determining the aggregate amounts of credit to be auctioned. Last resort lending, instead of being a distinct central-bank duty, would become an incidental counterpart of ordinary monetary policy. It would consist of that part of auctioned credits taken up by liquidity-strapped counterparties that choose to participate in auctions only as a last resort. Thus, while there would still be last resort borrowers, there would be no last resort lending operations as such.

To maximize the effectiveness of this type of system, the Fed should expand its counterparties. That is, rather than maintaining its outdated primary dealer system of just 25 financial institutions, the Fed should allow all commercial banks eligible for discount window loans to participate in its routine credit auctions. By updating the primary dealer system in this manner, flexible open market operations would serve as a reliable source of liquidity both in ordinary times and during times of extreme financial distress. There would no longer be a need for discount windows or an assortment of narrowly designated lending facilities. Instead, the provision of last resort credit to liquidity-stricken institutions would be a by-product of the Fed's ordinary monetary policy. In the sense that monetary policy itself consists of providing system-wide liquidity, this type of flexible system would also enhance the effectiveness of the Fed's routine open market operations.

To ensure that the Fed would no longer use other lending facilities, Congress should restrict the Fed to these types of temporary expansions of open market operations. At a minimum, Congress should amend the Federal Reserve Act so that it eliminates the discount window and revokes the type of emergency lending possible through Section 13(3) of the act.

CONCLUSION

Historically, the Fed has sometimes effectively fulfilled its LLR function by providing liquidity to the entire market rather than allocating credit to specific firms. However, many of the Fed's LLR actions have been counter to the very principles that defined the classical LLR concept. Fortunately, the conditions that existed in 1913 necessitating a separate LLR function for central banks no longer exist. Given the sophistication of financial markets, the Fed can now create a single flexible open

market operation facility that would render last resort lending an incidental counterpart of ordinary monetary policy.

By allowing a broad set of potential applicants, perhaps using a wide range of eligible collateral, to compete for available funds, flexible open market operations would help *minimize* the Fed's credit footprint. This type of system would help prevent the Fed from taking part in either deliberate or inadvertent credit-allocation exercises for which fiscal rather than monetary authorities ought to be responsible. Put differently, this type of system would focus the Fed on adequately and efficiently supplying the most liquid form of the nation's money supply.

NOTES

1. Thomas M. Humphrey, "The Classical Concept of the Lender of Last Resort," Federal Reserve Bank of Richmond *Economic Review* (January/February 1975).

2. In March 2020, the Fed created the Primary Market Corporate Credit Facility for the purpose of buying corporate bonds directly from US companies and extending loans to those same companies. See Norbert Michel, "The Federal Reserve Should Not Help Congress Duck Its Responsibilities: Part 2," *Forbes*, April 27, 2020.

3. Renee Haltom and Jeffrey M. Lacker, "Should the Fed Do Emergency Lending?," Federal Reserve Bank of Richmond Economic Brief no. 14-07, July 2014.

4. Prior to the creation of the Fed, private clearinghouses played a key role in stemming banking panics by providing short-term loans to member banks. Though this arrangement worked to provide a LLR function, it was not sufficient to overcome the many problems of the 19th-century banking system, problems that ultimately led to popular support for a central bank. See Ellis W. Tallman and Jon Moen, "Liquidity Creation Without a Lender of Last Resort: Clearing House Loan Certificates in the Banking Panic of 1907," Federal Reserve Bank of Cleveland Working Paper no. 10-10, July 2010; Richard H. Timberlake Jr., "The Central Banking Role of Clearinghouse Associations," *Journal of Money, Credit and Banking* 16, no. 1 (1984); J. G. Cannon, "Clearing House Methods and Practices," in *Clearing Houses and Credit Instruments*, vol. 6, Publications of National Monetary Commission (Government Printing Office, 1911); and George Selgin, "The Case for Free Banking: Then and Now," Cato Institute Policy Analysis no. 60, October 21, 1985.

5. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review* 74, no. 5 (September/October 1992): 58.

6. For a more detailed historical overview, see Norbert Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation Backgrounder no. 2943, August 20, 2014.

7. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review* 74, no. 5 (September/October 1992): 61.

8. President Richard Nixon also tried to secure a bailout of Penn Central through the Defense Production Act, but Congress refused. See Christopher Lydon, "Patman Releases Report on Pennsy," *New York Times*, July 23, 1970.

9. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review* 74, no. 5 (September/October 1992): 62.

10. "Continental Illinois: A Bank That Was Too Big to Fail," Federal Reserve History, May 15, 2023.

11. Norbert Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation Backgrounder no. 2943, August 20, 2014.

12. Lawrence H. White, *Ending the Federal Reserve System's Overreach into Credit Allocation*, Testimony Before the Subcommittee on Monetary Policy and Trade of the House Committee on Financial Services, 113th Cong., 2nd sess., March 12, 2014.

13. Norbert Michel and Jai Kedia, "Restoring Sensible Asset Purchases," Reforming the Federal Reserve, Cato Institute.

14. George Selgin, "Reforming Last-Resort Lending: The Flexible Open-Market Alternative," in *Prosperity Unleashed: Smarter Financial Regulation*, ed. Norbert Michel (Heritage Foundation, 2017): 201–12.

Section 7.
A Glance at Interventions in Payment Services

The Federal Reserve (the Fed) is widely known for its role in setting monetary policy, but far less attention is devoted to its role in the payments system.[1] As the central bank of the United States, the Fed has leveraged its position to simultaneously regulate and compete with financial service providers. In doing so, the Fed has slowly taken over many of these services.

These expansions can be seen in cash services, check services, wire services, automated clearinghouse services, real-time payments services, and the prospect of a central bank digital currency (CBDC). Time after time, the government accused the market of failing to serve the public to justify further interventions. Yet, in each of these instances, the common thread has not been a failure in the market. Rather, the common thread has been that government policies have eroded private enterprise and entrenched state-driven alternatives. Instead of continuing this history, it's time to unwind the Fed's role in this system and privatize payments.

CASH SERVICES

It is often said that the Fed was created in 1913 to put a halt to the panics and bank runs that occurred during the period of so-called free banking and followed during the period defined by the National Banking Acts of 1863 and 1864. Even today, policymakers point to tales of "wildcat banks" that collected deposits and then disappeared into the night as a reason why the government needed to step in and take over the provision of money.[2] However, this reading of history is misleading.

While it is difficult to put an exact number on the issue, wildcat banking was far from the norm during this era.[3] And to the extent such banks did exist, they were not the root cause of panics. The bigger issue was that—despite this era being labeled as a period of free banking—banks were required by law to take on risky investments and prohibited from branching across state lines.[4] When this concentration of risk led to failure, the government responded by consolidating the state-based banking system of banknote issuance into a national banking system and then consolidating that system further into one managed by the Fed.[5] In effect, this entry into payments became what would be the first of many examples of the government undermining the market and then inserting itself to fix the problem it had created.

CHECK SERVICES

Check settlement is another service that began when the Fed was first getting started. In general, check settlement involves collecting checks, processing the information, and then directing payments. As one might assume, there is nothing that inherently requires the government to intervene to accomplish this task. Rather, once again, this role is built upon the US government distorting the market.

As the story is often told, "[By] taking advantage of its nationwide reach, [the Fed] was uniquely positioned to streamline check collection."[6] This unique position was not due to market failure. The problem was created by the US government—it was illegal until the 1990s for banks to branch across state lines.[7] The market did respond with clearinghouses and correspondent banks, but then the Fed undermined these solutions by not charging for its check processing services.[8] Nearly 30 percent of the Fed's employees were working on check processing in 1974, and yet it did so without fees.[9] In effect, "many local check clearinghouses could not compete and closed down."[10] The share of checks processed by the Fed decreased when Congress required fees to cover costs in the 1980s, but the Fed had already carved out market dominance.[11]

WIRE SERVICES

The Fed also began providing wire services early in its history. The term "wire" is in reference to how the instructions for these payments were originally sent over telegraph wires. In its simplest form, however, a wire service is a way to have funds transferred between reserve accounts. As the Fed describes it, offering wire services was important in the early 1900s because the "US banking system was fragmented geographically" and "no single institution had national operations to act as an intermediary for payments."[12]

As with both cash and check services, this telling of history misses the fundamental issue. It was not a market failure that caused a lack of national operations. The root problem was instead that it was illegal for banks to branch across state lines. Had they been able to do so, both the necessary infrastructure and relationships could have been developed. Instead, the Fed's only advantage was that it was given legal privileges that tilted the playing field.

AUTOMATED CLEARINGHOUSE SERVICES

The Fed is one of two organizations currently operating an automated clearinghouse (ACH)—effectively, an electronic check collection system. Banks group outgoing payments (either credits or debits) into batches, send these batches to an ACH electronically, and then the operator of the ACH sorts through the payments to get the money where it needs to go.

The origins of the ACH system can be traced back to the late 1960s when private-sector associations began investigating improvements to check processing. In 1972, the first ACH association was formed in California with support from the Fed.[13] By 1978, the Fed managed a national network of ACH systems.[14] Across this system, the Fed subsidized services such that prices did not reflect the true cost of doing business.[15] Had ACH adoption depended on profit and loss, the system could have evolved into better, and more diverse, services. Instead, early government interventions effectively locked the US payments system into a less dynamic, less private system than what the market might have produced.

REAL-TIME PAYMENTS SERVICES

FedNow is a real-time payments system designed to allow banks to transfer funds instantly. Whether FedNow is really needed remains an open question. For years, the Fed shelved improvements that could have been made to its existing services. It was only after the private sector created a faster payment system that the Fed announced FedNow.

The Fed delivered a call to action in 2012: Payments needed to settle faster, more efficiently, and more effectively.[16] Over the next five years, the Fed convened task forces, held meetings, and published reports.[17] During this period, the idea of improving existing systems (e.g., expanding operating hours) repeatedly came up as a low-cost way to increase the speed of payments. Although the private sector introduced a new faster payments system in 2017, the Fed announced in 2019 that it would launch FedNow in 2023.[18] Seemingly repeating history, FedNow has cost $1.1 billion, but the Fed has waived monthly service fees and discounted transfer fees year after year. The law requires that the Fed recoup its costs. However, the Fed argued that pricing the service to recoup costs "would result in prohibitively high or unnecessarily volatile pricing."[19]

CENTRAL BANK DIGITAL CURRENCY

The United States does not currently have a central bank digital currency (CBDC), but the arguments for a US CBDC mirror the justifications used for the Fed's previous expansions. At its most basic level, a CBDC allows the public to make payments digitally in a system provided directly by the central bank. The creation of a CBDC would be another instance of the Fed intervening where it isn't needed.

Consider the argument that a CBDC would improve financial inclusion. Although many central bankers have made this claim, arguing that a CBDC is needed ignores the progress the private sector has made.[20] First, the rise of mobile banking has largely eliminated "inconvenient locations" as a reason for not having a bank account.[21] Second, many banks have worked to offer entry-level accounts with little to no fees so that people have an opportunity to build a banking relationship that was

otherwise unaffordable. Third, alternatives like prepaid cards, fintech services, and cryptocurrencies have reduced the cost of living without a bank account. Put simply, the market is working. There is no need for the government to intervene with a CBDC.

RECOMMENDATIONS TO PRIVATIZE PAYMENTS

The Fed never should have taken over these payments services. It's time to end the Fed's involvement and return these functions to the private sector. Policymakers have two options: a direct solution and an indirect solution.

The most direct solution is to get the Fed out of the payments system entirely. At a minimum, that could mean separating functions such that the Fed does not simultaneously act as a competitor and a regulator. To better privatize payment functions, however, each of the services currently provided should be phased out of public services completely. Doing so would allow the private sector to take over services and minimize disruptions during the transition.

To ease the transition, services could be rolled back in reverse chronological order. Congress could begin by taking a US CBDC off the table. Then, attention could turn to FedNow, followed by ACH services, and so on. Doing so would allow the private sector to build upon the most familiar services before turning to services that had been taken over long ago.

An indirect solution is to strengthen legislation that was meant to level the playing field: the 1980 Depository Institutions Deregulation and Monetary Control Act. Among other things, this legislation was supposed to prevent the Fed from unfairly competing with the private sector, but it failed to set sufficiently binding constraints on the Fed.[22] By allowing the Fed to establish its own criteria for measuring success and then change the criteria as it goes, the law fails to adequately restrict the activities of the central bank. That much should be evident given the Fed's argument that adhering to the law's cost-recovery provisions as applied to other services would result in "prohibitively high" pricing.[23]

Congress should establish concrete deadlines so that the Fed is actually required to recover its costs when offering services. Furthermore, Congress should also require that the Fed's compliance with the Depository Institutions Deregulation and Monetary Control Act's cost-recovery provisions be subject to regular audits by third parties so that there is no question as to how the central bank covers its costs.

CONCLUSION

The Fed's role in the payments system may not get the same public attention as its role in monetary policy, but the expansions that have taken place over the past 100 years should not go unnoticed. Since the creation of the Fed in 1913, the market has been undermined by government favoritism, subsidized pricing, and barriers to entry. In doing so, the government has discouraged or outright prevented the private sector from building the financial infrastructure needed to support payments. If competition, innovation, and true inclusion matter, we must question why the central bank still runs payments—and demand it step aside.

NOTES

1. Due to limits on the word count of this publication, "the Federal Reserve" (abbreviated as "the Fed") is used to refer to both the Board of Governors of the Federal Reserve System and the regional Federal Reserve banks. Furthermore, this publication is meant to offer only a brief history of the Fed's interventions in the payments system.

2. For the purposes of this brief publication, banking history in the United States can be divided into three main periods: 1837–1862, 1862–1913, and 1913–present day. The first period (1837–1862) is what most people refer to when describing the US free banking experience. It was a time when state-chartered banks could issue their own notes, and it worked relatively well—far better than what has been claimed by critics. That began to change in the second period (1862–1913) with a series of federal government interventions. Among them, the combination of the Legal Tender Acts of 1862 and 1863, National Banking Acts of 1863 and 1864, and the Revenue Act of 1865 resulted in the US government issuing its own notes (the greenback), a system for federally chartered banks, the creation of the Office of the Comptroller of the Currency to oversee this new system, and a tax on notes issued by state-chartered banks. In short, 1862–1913 was a period of consolidation. The third period (1913–today) characterizes the completion of that consolidation with the creation of the Federal Reserve. Kevin Dowd, *The Experience of Free Banking* (Institute of Economic Affairs, 2023); George Selgin, "The Fable of the Cats," *Cato at Liberty* (blog), Cato Institute, July 6, 2021; and George Selgin, "Real and Pseudo Free Banking," *Cato at Liberty* (blog), Cato Institute, July 23, 2015.

3. George Selgin, "The Fable of the Cats," *Cato at Liberty* (blog), Cato Institute, July 6, 2021.

4. As George Selgin has documented, "The free banking laws of several states forced banks to invest in what [were] very risky securities—and especially in risky state government bonds—while the rule against branching limited their ability to diversify around this risk, especially by relying more on deposits than on notes. It was owing to these restrictive components of U.S.-style free banking that scads of American free banks ended up going bust." George Selgin, "Real and Pseudo Free Banking," *Cato at Liberty* (blog), Cato Institute, July 23, 2015.

5. Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996).

6. "Check Payments," Federal Reserve History, September 28, 2023.

7. "Check Payments," Federal Reserve History, September 28, 2023.

8. Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996).

9. "Check Payments," Federal Reserve History, September 28, 2023.

10. Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996).

11. Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996).

12. "Fedwire," Federal Reserve History, August 28, 2023.

13. Terri Bradford, "The Evolution of the ACH," Payments System Research Briefing, Federal Reserve Bank of Kansas City, December 2007; and "History of Nacha and the ACH Network," Nacha, April 20, 2019.

14. James McAndrews, "The Automated Clearinghouse System: Moving Toward Electronic Payment," Federal Reserve Bank of Philadelphia *Business Review*, July/August 1994.

15. "At its inception, ACH processing required a very significant investment in computer technology. Only a large organization like the Federal Reserve System, with its established technical infrastructure and its extensive access to capital, was in a position to invest in a venture of this magnitude, for which the return was still uncertain. Moreover, the volume of payments at ACH's inception was not sufficient to justify the costs of the large initial investment for most companies." Bruce J. Summers and R. Alton Gilbert, "Clearing and Settlement of US Dollar Payments: Back to the Future?," Federal Reserve Bank of St. Louis *Review* 78, no. 5 (September/October 1996); Alan Greenspan, "Remarks at the US Treasury Conference on Electronic Money and Banking: The Role of Government," Federal Reserve Bank of St. Louis *Statements and Speeches of Alan Greenspan 1987–2005*, September 19,

1996; "ACH Shakeout: Two Players Retrenching," American Banker, December 3, 2002; Board of Governors of the Federal Reserve System, "Federal Register Notice: Federal Reserve ACH Deposit Deadlines and Pricing Practices for Transactions Involving Private-Sector ACH Operators," *Selected Regulations of the Board of Governors of the Federal Reserve System 1998–2015*, November 3, 2000; and "History of Nacha and the ACH Network," Nacha, April 20, 2019.

16. Sandra Pianalto, "Collaborating to Improve the US Payments System," Federal Reserve Bank of Cleveland, October 22, 2012, last archived July 17, 2024.

17. Sandra Pianalto, "Collaborating to Improve the US Payments System," Federal Reserve Bank of Cleveland, October 22, 2012, last archived July 17, 2024; "Payment System Improvement—Public Consultation Paper," Federal Reserve Banks, September 10, 2013; "Strategies for Improving the US Payment System," Federal Reserve System, January 26, 2015; and "Strategies for Improving the US Payment System: Federal Reserve Next Steps in the Payments Improvement Journey," Federal Reserve System, September 6, 2017.

18. "Federal Reserve Announces Plan to Develop a New Round-the-Clock Real-Time Payment and Settlement Service to Support Faster Payments," press release, Board of Governors of the Federal Reserve System, August 5, 2019.

19. "2023 FedNow Service Pricing Now Available," FedNow Explorer, Federal Reserve Banks, November 8, 2022; "Federal Reserve Announces That Its New System for Instant Payments, the FedNow Service, Is Now Live," press release, Board of Governors of the Federal Reserve System, July 20, 2023; "Payment System and Reserve Bank Oversight," *110th Annual Report of the Board of Governors of the Federal Reserve System* (Board of Governors of the Federal Reserve System, 2023); and Federal Reserve Bank Services, 89 Fed. Reg. 93584 (November 27, 2024).

20. As explained at length in my book, there are many other problems with the idea that a central bank digital currency would be a solution for financial inclusion. Nicholas Anthony, *Digital Currency or Digital Control? Decoding CBDC and the Future of Money* (Cato Institute, 2024).

21. Garret Christensen et al., *FDIC National Survey of Unbanked and Underbanked Households* (Federal Deposit Insurance Corporation, 2023).

22. The 1980 Depository Institutions Deregulation and Monetary Control Act touched on many issues. For example, it deregulated the financial system by removing caps on interest rates paid for deposit accounts. However, the law also increased regulatory burdens by requiring that all depository institutions meet reserve requirements. This requirement was previously limited to institutions with accounts at the Federal Reserve. The law also expanded the supervisory role of the Fed by authorizing it to require financial institutions to submit financial reports. Committee on Banking, Finance, and Urban Affairs, Depository Institutions Deregulation and Monetary Control Act of 1980, US House of Representatives, 96th Cong., 2nd Sess., Report no. 96-221, 1980.

23. Federal Reserve Bank Services, 89 Fed. Reg. 93584 (November 27, 2024).

Section 8.
Shrinking Regulatory Authority

The Fed's primary focus is monetary policy, with its dual mandate of stable prices and maximum employment. While the Fed has been involved in banking regulation since its founding in 1913, a central bank does not need to be a financial regulator to conduct monetary policy. Moreover, the Fed's role as a financial regulator creates a conflict of interest between its mandates to stabilize the economy and preserve the financial standing of the banks that are under its supervision. For instance, the Fed's regulatory role may increase the likelihood that last resort lending decisions will be compromised as the Fed's employees become embedded in the financial firms they are supposed to be overseeing.[1]

More broadly, banks do not need three federal banking regulators: the Fed, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC). The OCC, for example, has no conflict of interest with monetary policy and could adopt the regulatory powers of the Fed. Simply removing the Fed from its regulatory role would leave at least five other federal agencies that oversee US financial markets. The Fed is now micromanaging even more firms than it was prior to the 2008 crisis, even though it has repeatedly failed to predict, much less prevent, financial turmoil. At the minimum, removing the Fed's regulatory powers would help insulate it from the political pressures that come from regulating the nation's largest financial institutions.

A HISTORY OF FAILURE AS A REGULATOR

The Federal Reserve has been involved in regulating banks since its inception, and with the Banking Act of 1933, commonly known as the Glass–Steagall Act, the Fed became the regulator for all holding companies owning a member bank. When bank holding companies, as well as their permissible activities, became more clearly defined under the Bank Holding Company Act of 1956, the Fed was named the primary regulator for *all* bank holding companies. Under the 1999 Gramm–Leach–Bliley Act, the Fed alone approved applications to become a "financial holding company"—and only after certifying that both the holding company and all its subsidiary depository institutions were "well-managed and well-capitalized, and . . . in compliance with the Community Reinvestment Act, among other requirements."[2]

Although the Fed is not solely to blame, the fact remains that the US experienced major bank solvency problems during the Depression era, again in the 1970s and 1980s, during the Great Recession of the late 2000s, and recently with a string of post-pandemic bank failures, including Silicon Valley Bank (SVB) in 2023.[3] At best, the Fed did not see these crises coming, even though it was heavily involved (more so in the later crises) in regulating banks' safety and soundness.[4] Simply being mistaken is one thing, but the Fed played a significant role in developing the capital ratios used to measure that safety and soundness.

In the 1950s, the Fed developed a "risk-bucket" approach to capital requirements. That method became the foundation for the Basel I capital accords, which the Fed and the FDIC adopted for US commercial banks in 1988.[5] Under these capital rules, US commercial banks have been required to maintain several different capital ratios above regulatory minimums in order to be considered well capitalized. In fact, the FDIC reported that US commercial banks exceeded these requirements by an average of 2 to 3 percentage points for the six years leading up to the 2008 financial crisis.[6] Not only did the Basel accords fail to prevent the crisis, they sanctioned and effectively encouraged, via low-risk weights, investing heavily in

mortgage-backed securities (MBS) that contributed to the 2008 meltdown. Furthermore, the Fed (in conjunction with the OCC, FDIC, and Office of Thrift Supervision) was directly responsible for the recourse rule, a 2001 change to the Basel capital requirements that applied the same low-risk weight for Fannie Mae– and Freddie Mac–issued MBS to highly rated private-label MBS.[7]

In March 2023, SVB and Signature Bank failed, again triggering much anger toward financial institutions and the "big" banks. But Congress should not absolve federal regulators from major failures. For instance, examiners at the San Francisco Fed, which was the supervisor for SVB, failed to adequately mitigate SVB's interest rate risk. At the same time, the Fed's Federal Open Market Committee was sharply increasing the policy rate to combat post-pandemic inflation. To its credit, the Fed acknowledged its supervisory mistakes leading up to SVB's failure.[8]

CONFLICT WITH MONETARY POLICY

The Fed has a dual mandate to stabilize inflation and support maximum employment using its monetary policy tool kit. But there is a clear conflict of interest when the same institution is both the nation's central bank and a primary regulator of large financial institutions. This conflict can be particularly severe when the Fed's disinflationary policy actions create financial stress within the very institutions the Fed supervises.

Monetary tightening, by its nature, involves creating adverse financial conditions, because increasing the policy rate eventually leads to elevated borrowing costs.[9] To lower inflation, the central bank must reduce aggregate demand, often by tightening credit, sometimes even triggering corrections in asset prices. But such a policy can expose vulnerabilities in financial institutions, particularly those with maturity mismatches or concentrated risk exposures. When the same entity setting policy is also tasked with ensuring institutional stability, the temptation arises to compromise one to protect the other.

The 2023 collapse of SVB provides a clear case study of this dynamic. SVB was a state-chartered member bank supervised by the Fed. It had grown rapidly during the low-rate environment of the COVID-19 pandemic, amassing a large, uninsured deposit base heavily concentrated in the tech sector. At the same time, SVB invested in long-dated securities whose market value was highly sensitive to rising rates, and it failed to hedge that interest rate risk. When the Fed began rapidly tightening in 2022 to combat inflation, SVB's unrealized losses mounted. As depositors began pulling out funds, the bank failed.[10] This failure of supervision intersected directly with the Fed's macroeconomic stance: The same interest rate hikes needed to tame inflation also threatened the stability of an institution under the Fed's regulatory umbrella.

In the aftermath, the Fed—along with the Treasury Department and FDIC—invoked the systemic risk exception to guarantee all of SVB's uninsured deposits.[11] Simultaneously, the Fed introduced the Bank Term Funding Program, offering loans against long-term securities at par, effectively shielding other banks from similar market losses.[12] These crisis interventions, while stabilizing in the short run, led to a strange outcome: The Fed was using emergency liquidity to undo the financial effects of its own disinflationary policy.

This dual role weakens the Fed's credibility. If financial instability routinely triggers backstops and the creation of lending facilities, market participants may reasonably expect that monetary tightening will be partially offset when stress emerges. In effect, the central bank becomes a hostage to its regulatory responsibilities—tempted to ease at the first sign of trouble in the institutions it oversees, thus dampening the effects of disinflationary monetary policy. Separately, the Fed faces pressure to lend to insolvent institutions to enhance its expansionary monetary policies.

SUGGESTIONS FOR REFORM

Given the multiple instances of the Fed's failures as a regulator, the abundance of other regulatory agencies, and the conflict of interest that arises from the Fed supervising banks while conducting monetary policy, the first-best solution is to eliminate the Fed's regulatory authority altogether.[13] If members of Congress are unwilling or unable to enforce such a reboot, here

are several other intermediate measures that could be implemented:

- Make the Office of the Comptroller of the Currency the (only) federal regulator for all banks with more than $15 billion in assets. Admittedly, this is an arbitrary cutoff, but it would leave the OCC regulating about 100 banks. The threshold choice could be set and adjusted as desired, preferably with an inflation-adjusted threshold that always places roughly 100 of the largest banks under the OCC's supervision.[14]
- Make Fed district banks the federal regulator for banks in their respective districts with less than the threshold chosen for "large" banks.
- Eliminate the position of the Fed's vice chair for supervision.

CONCLUSION

The Fed has been tasked with regulating financial institutions since its inception. Yet there have been several financial crises and bank failures under its watch. In addition, there is a serious conflict of interest between the Fed's mandate to stabilize prices and its regulatory responsibilities, as tightening credit market conditions to suppress demand and thereby prices can jeopardize the very institutions the Fed oversees. Having the Fed serve as a regulator is particularly unnecessary given that there are several other federal institutions tasked with regulating banks. Optimally, Congress would remove all of the Fed's regulatory powers. In the absence of such a change, Congress could implement intermediate reforms to ensure the fewest spillover effects from the Fed's role as a regulator.

NOTES

1. In practice, regulators build relationships with employees at large banks because teams of regulators work in those institutions literally every day. Additionally, employees from large banks often leave to work for federal regulatory agencies and vice versa.

2. Dafna Avraham et al., "A Structural View of US Bank Holding Companies," Federal Reserve Bank of New York *Economic Policy Review* 18, no. 2 (July 2012): 65–81. To be fair, this bill was an overall positive as it repealed the parts of the Glass–Steagall Act that prevented banking, securities, and insurance firms from affiliating across sectors.

3. For more on the Fed's regulatory failures, see Norbert Michel, "A Roadmap to Monetary Policy Reforms," *Cato Journal* 35, no. 2 (Spring/Summer 2015): 315–29.

4. In 2008, for example, Fed Chairman Ben Bernanke testified before the Senate that "among the largest banks, the capital ratios remain good and I don't anticipate any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system." See "Fed Chairman: Some Small US Banks May Go Under," CNBC, February 28, 2008.

5. Howard D. Crosse and George H. Hempel, *Management Policies for Commercial Banks*, 2nd ed. (Prentice-Hall, 1962), pp. 169–72.

6. Juliusz Jablecki and Mateusz Machaj, "The Regulated Meltdown of 2008," in "Causes of the Financial Crisis," special issue, *Critical Review* 21, nos. 2–3 (2009): 306–7.

7. See Jeffrey Friedman and Wladimir Kraus, *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (University of Pennsylvania Press, 2011); Norbert Michel and John Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation Backgrounder no. 2905, April 23, 2014; and Stephen Matteo Miller, "The Recourse Rule: How Regulatory Capture Gave Rise to the Financial Crisis," Mercatus Center at George Mason University, January 15, 2019.

8. The Fed and the Government Accountability Office (GAO) each released reports on these bank failures that reveal serious shortcomings of the US regulatory framework, problems that go well beyond the Fed or its role in regulation. See Norbert Michel, "SVB Reports from the Fed and GAO Reveal Regulators Long Knew of Problems," *Cato at Liberty* (blog), Cato Institute, May 3, 2023.

9. The method of transmission is slow, indirect, and less

powerful since the GFC, but generally when the Fed uses its tools to raise the policy rate, it tightens credit conditions.

10. Andrew Metrick, "The Failure of Silicon Valley Bank and the Panic of 2023," *Journal of Economic Perspectives* 38, no. 1 (Winter 2024): 133–52.

11. "Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC," Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Department of the Treasury, press release, March 12, 2023.

12. "Bank Term Funding Program," Financial Stability, Board of Governors of the Federal Reserve System, updated April 11, 2025.

13. For more on why it is unnecessary to have so many federal financial regulators, see Norbert Michel and Jennifer J. Schulp, *Financing Opportunity* (Cato Institute, 2024).

14. If this policy prescription is not heeded and the Fed is to continue regulating large banks, then the least policymakers can do is completely overhaul the Fed's capital requirement rules, which are overly complex and redundant. For more on this topic, see Norbert Michel, "From Basel to Baffling: It's Time to Simplify Bank Capital Rules," *Forbes*, July 29, 2025.

Section 9.
Dispelling Myths About the Fed

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]

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.

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About the Contributors

Nicholas Anthony is a policy analyst at the Cato Institute's Center for Monetary and Financial Alternatives, a fellow at the Human Rights Foundation (HRF), and a member of the Economic Inclusion Group's Advisory Board. Anthony's research covers a wide range of topics within the field of monetary and financial economics, including central bank digital currency (CBDC), financial privacy, cryptocurrency, and the use of money in society. Anthony is the author of *Digital Currency or Digital Control? Decoding CBDC and the Future of Money* and his work has been published in the *Wall Street Journal*, *MarketWatch*, *Business Insider*, and numerous other outlets.

Jai Kedia is a research fellow at the Center for Monetary and Financial Alternatives. His research lies within the fields of monetary economics and macrofinance. As an empirical economist, he employs various econometric tools to analyze the interactions between monetary policy or financial variables and business cycle indicators such as inflation and GDP.

Norbert J. Michel is vice president and director of the Cato Institute's Center for Monetary and Financial Alternatives. Michel leads a team of nearly one dozen scholars that develop original policy solutions to expand freedom through improving financial markets and monetary policy. In addition to producing policy publications, his team regularly engages with policymakers on Capitol Hill. Michel is also the author of the book *Crushing Capitalism: How the Stagnation Narrative is Threatening the American Dream*, and coauthor of *Financing Opportunity: How Financial Markets Have Fueled American Prosperity for More than Two Centuries*.

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1000 Massachusetts Ave. NW
Washington, DC 20001
www.cato.org