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HANDBOOK ON AFFORDABILITY

1. Monetary Policy

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The post-2021 inflation surge reset the price level upward, heightening anxiety about “affordability.” In any given year, some prices, such as for housing and pharmaceuticals, may rise faster than others due to sector-specific supply-and-demand conditions. But all prices share a common macroeconomic determinant: the purchasing power of money. Quite simply, there is no durable economy-wide solution to affordability concerns without a low, stable rate of inflation.

Achieving this requires good management of the US money supply and the value of the dollar. Congress has tasked the Federal Reserve with such management under its dual mandate of stable prices and maximum employment. Overall, the Fed has a poor record of delivering price stability. Under its watch, inflation hit a 40-year high in the aftermath of the COVID-19 pandemic. The Fed was too slow to tighten policy in light of rapidly growing levels of money spending across the economy. Yet politicians increasingly want the Fed to try to fix everything, from housing costs to our ever-increasing federal debt burden.

The Fed should not be tasked with these extraneous responsibilities that seek to pick winners and losers in various sectors of the economy. Not only is the Fed limited in how much it can help specific sectors, but broadening its objectives will also necessarily distract its focus from price stability, a task it already finds difficult enough to accomplish. After all, the Fed can only influence aggregate nominal conditions. It cannot repeal real constraints or override underlying supply-and-demand fundamentals that can also drive changes in the price level.

Ideally, the US monetary system would be fully private, with aligned incentives and competition. But the Fed and the US dollar are so entrenched in our financial system, removing them without viable alternatives would result in

high economic costs during the transition. Such a drastic change would also require years of political navigation. This section therefore focuses on more immediate fixes that Congress or the Fed itself can implement to improve price stability.

The Fed implements monetary policy mainly by influencing short-term borrowing costs to pursue its macroeconomic goals. This transmission mechanism is indirect and imperfect. At best, the Fed can foster better business conditions during turbulent economic periods by setting policy objectively and transparently. At worst, the Fed can set its targets so poorly that monetary policy itself becomes a source of economic volatility, especially when the Fed enjoys broad discretion and is burdened with mandates beyond its fundamental mission. Congress should therefore narrow the Fed’s responsibilities and focus on reforms that bind it to transparent, objective monetary policy.

FEDERAL POLICIES TO AVOID HIGH INFLATION

- **Adopt rules-based monetary policy.** Congress should mandate that the Fed conduct rules-based monetary policy. The 2015 FORM Act offers a template for such legislation. Under such a system, the Federal Open Market Committee (FOMC) would set the interest rate target according to an arithmetic rule linking the interest rate to macroeconomic indicators such as inflation relative to target and a measure of economic slack (e.g., unemployment or an output gap), rather than using ad hoc discretion. The FOMC could revise the rule at preset intervals, perhaps at the framework review it conducts every five years. But while the rule is in effect, the FOMC must follow it.

Any deviation from the rule should require a public written justification, a clear plan to return to the rule, and testimony to Congress. A rules-based system would tend to anchor inflation expectations, reduce policy-driven volatility, and lower inflation risk premia in borrowing costs. It would also help shield the Fed from political pressure to lower rates aggressively, so risking higher inflation.

- **End the interest-on-reserves program.** Congress must revoke the Fed’s ability to pay interest on bank reserves. Under this system, known as IOR, the Fed has transferred billions of dollars from the Treasury to large banks. IOR contributed to the Fed losing nearly \$200 billion in 2023 and 2024, as higher interest rates ballooned payments. This quasi-fiscal policy leads to a conflict of interest with the Fed’s mandate of price stability, because tighter policy mechanically means larger interest payments to banks. And because these payments show up as reduced remittances to the Treasury, IOR functions as a backdoor spending channel, effectively allowing the funding of projects outside the normal appropriations process by creating a “deferred asset” on its balance sheet.
- **Exercise balance sheet discipline.** Concurrently with the end of IOR, Congress must force the Fed to reduce the size of its balance sheet and tightly constrain future large-scale asset purchases through its policy of “quantitative easing.” Otherwise, in the next downturn, the Fed will again be tempted to massively

expand its balance sheet. Injecting such excess liquidity into the economy can drive money growth, as it did post-pandemic, eroding the value of the dollar and raising the price level. Congress should mandate that the Fed revert its balance sheet to pre-financial-crisis levels by limiting the Fed’s assets to 10 percent or less of US commercial banks. Importantly, Congress must provide the Fed with an appropriate timeline (ideally 5 to 10 years) to achieve this—not so short that it releases too many reserves into the US economy too quickly, but not so long as to beget inaction.

- **Remove the Fed from bank supervision and financial stability roles.** The Fed should be removed from its role as a financial supervisor and regulator. When the Fed increases rates to fight inflation, this tightening can expose losses and liquidity strains at the same banks the Fed is supposed to supervise. Separating this regulatory function from monetary policy would therefore sharpen accountability and help keep the Fed focused on price stability. There are several other financial regulators—the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, to name two—that could subsume the Fed’s supervisory responsibilities. Finally, Congress should remove all financial stability mandates it has placed on the Fed, such as those in Title I and Title II of the 2010 Dodd–Frank Act. These types of mandates serve only to further distract the Fed from its core monetary responsibilities.