The Fed's New "Gain-of-Function" Monetary Policy

Overuse of nonstandard policies, mission creep, and institutional bloat are threatening the central bank's monetary independence.

By Scott Bessent

As we saw during the covid pandemic, when lab-created experiments escape their confines, they can wreak havoc in the real world. Once released, they cannot easily be put back into the containment zone. The "extraordinary" monetary policy tools unleashed after the 2008 financial crisis have similarly transformed the U.S. Federal Reserve's policy regime, with unpredictable consequences. The Fed's new operating model is effectively a gain-of-function monetary policy experiment.

The Fed's adoption of large-scale asset purchases as a tool of monetary policy when its traditional instrument—the overnight interest rate—was at the zero lower barrier created severe distortions in the market, with unintended consequences. And it has disturbed the Fed's unique independent role in the U.S. political system. Central bank independence is fundamental to the economic success of the United States.

The Fed must change course. Its standard monetary policy toolkit has become too complex to manage, with uncertain theoretical underpinnings and problematic

---

Scott Bessent is Secretary of the Treasury of the United States.

economic consequences. Gain-of-function monetary policy must be replaced with simple and measurable policy tools to achieve a narrow mandate. Such an approach is the clearest and most effective way to deliver better economic outcomes and safeguard central bank independence over time.

UNCONVENTIONAL MONETARY EXPERIMENTS, NOT POLICY

In the aftermath of the 2008 financial crisis, the Fed was understandably determined to help revitalize the American economy. It had just successfully modernized its traditional responsibility as a lender of last resort, helping to stabilize the financial system. This role, as described by Walter Bagehot in *Lombard Street* (1873), is a time-tested function for central banks in managing liquidity crises. While the complexity of modern credit markets necessitated innovations in program design, the principles guiding the Fed's intervention were well-worn.

Buoyed by its perceived success in combating the financial crisis, the Fed began placing increasing faith in its ability to steer the economy. This confidence was reinforced by growing frustration with political gridlock in Washington, which appeared unable to address the economic damage inflicted by the Great Recession. The mantra that "central banks are the only game in town" gained widespread traction amongst policymakers.

Against this backdrop, the Fed extended its liquidity tools into uncharted territory, repurposing asset purchase programs as instruments of stimulative monetary policy.

The Fed's new operating model is effectively a gain-of-function monetary policy experiment.

This experiment ignored the fact that even the impacts of changes to short-term interest rates—a relatively well-developed and allegedly well-understood tool—are often unpredictable.

The challenges in assessing the transmission of monetary policy are magnified when it comes to unconventional policy instruments such as large-scale asset purchases, also known as quantitative easing (QE). These tools were designed to stimulate the economy through various channels, none of which are well understood. Lower long-term interest rates, in theory, would encourage borrowing for business investment and other productive activities that would raise real economic output. Higher asset prices

Central bank independence is fundamental to the economic success of the United States.

driven by lower interest rates were expected to generate a "wealth effect" as newly flush consumers spent more, boosting economic growth. Additionally, reducing the supply of government securities in the market was intended to push investors toward riskier investments, thereby stimulating greater economic activity through what is known as the "portfolio balance" channel.

However, the precision with which the Fed can gauge the impact of these tools remains extremely limited. Monetary economists have tried to quantify the impact of unconventional monetary policies in terms of an equivalent short-term interest rate. According to a leading model, the Wu-Xia Shadow Fed Funds Rate, the Fed's adoption of unconventional tools during the 2010s pushed the effective nominal interest rate to as low as -3 percent by May 2014. Despite these deeply negative nominal interest rates, the U.S. economy never experienced the kind of nominal GDP boost that such a stance would have suggested.

Other scholarship has arrived at different conclusions. A 2017 paper from the Bank for International Settlements found that QE had a *de minimis* impact on real output, but a statistically significant impact on equity prices that was more than ten times the magnitude of the effect on real output. However, then-Fed Chair Ben Bernanke had no doubts as to the effectiveness of unconventional monetary policies, famously stating in 2014 that, "the problem with QE is it works in practice, but it doesn't work in theory." The Fed's confidence in its powerful new tools resembles that of a central planner who assures their subjects that the grand scope of their powers and their prescience will lead to inexorable prosperity. But despite Bernanke's insistence, the mystery of the effects of QE—intended and unintended—remains.

UNPREDICTABLE CONSEQUENCES IN THE REAL WORLD

One might think that all these new tools and the centralization of the U.S. financial market on Constitution Avenue would have given the Federal Open Market Committee greater visibility into the economy's direction of travel. At a minimum, all those "gained functions" should have allowed the FOMC to more effectively steer the economy onto their desired path. That did not happen because the Fed simply does not comprehend how the new gain-of-function monetary policy works.

In its November 2009 *Summary of Economic Projections,* the Fed forecast that real GDP would grow by 3 percent in 2010 and accelerate to 4 percent in 2011, expecting that its new "gain-of-function" monetary tools and a large fiscal deficit would stimulate the real economy. Actual growth in 2010 came close, at 2.8 percent, but instead of accelerating, growth slowed to 1.6 percent in 2011. At the end of 2010, the FOMC still projected 4 percent annual growth for both 2012 and 2013. In reality, growth reached only 2.3 percent in 2012 and 2.1 percent in 2013.

During the first six years of this regime, the Fed's average one-year-ahead forecast error for real GDP was 0.6 percentage points—a sizable miss when the target value is typically around 2 percent—while two-year-ahead errors averaged an even larger 1.2 points. Cumulatively, the Fed's two-year forward projections overstated real GDP by 7.6 percent, projecting an economy that would have been more than $1 trillion larger (in 2009 dollars) than the actual result. These repeated misses reveal that the Fed placed too much faith in its own abilities and in expansionary fiscal policy to spur growth.

Conditions shifted when the Trump administration pivoted fiscal policy toward tax cuts and deregulation to strengthen the economy's supply side. For the three pre-covid years of that administration (2017–2019), the Fed's one-year-ahead growth forecasts were consistently too low. Yet optimism about fiscal stimulus resurfaced after President Biden's election. The clearest example was the assertion that the inflation

The Fed's Policy: "Socialism for Investors, Capitalism for Everyone Else"

Unconventional monetary policies do have important bastions of support. But these sources raise important questions about the propriety of these policies. Pillars of the academic economics profession—Ben Bernanke and Janet Yellen—pioneered the expansion of the Fed's toolkit in the 2010s. Unsurprisingly, academic economists are some of the strongest supporters of the Fed's expanded role.

Financial markets are the other major cheerleader for unconventional monetary policies. This is not surprising given that the Fed's monetary innovations are intended to work by boosting asset markets. As the Fed pushes down interest rates, prices of fixed income instruments mechanically increase, and other assets are bid up by the Fed's deliberate desire to push investors further out on the risk curve. Despite scant evidence that this policy resulted in increased real economic output, it clearly created a significant support base for unconventional monetary policy in the financial markets, which are highly attuned to the presence of the "Fed put" due to the Fed's repeated financial rescues. This has fueled the increase in long-only investing strategies, principally low-cost index funds and private equity, reducing the potential for the capital markets to be a disciplining force through price discovery.

Notably, critics of the Fed's unconventional tools have appeared on both sides of the economics discipline, suggesting a convergence among the relatively small group of individuals who—regardless of political persuasion—have the requisite expertise to understand the effects of QE and are also not captured by the hierarchy of the academic economics or by market incentives.

In her book *Engine of Inequality: The Fed and the Future of Wealth in America* (2021), progressive financial policy expert Karen Petrou documents how the Fed's pursuit of a "wealth effect" to stimulate the economy backfired. "Unprecedented inequality," wrote Petrou, "is clear proof that the wealth effect is all too effective for the wealthy, but an accelerant to economic hardship for everyone else." Economists' focus on the supposed benefits of the wealth effect is particularly odd given that the Fed's asset purchases act more powerfully on the discount rate at which assets are valued than the stream of cash flows that underpins the asset's price. Asset owners are less likely to bring forward consumption as a result of changes in the discount rate than income growth, and to the

©IMF

Progressive financial policy expert **Karen Petrou** *documents how the Fed's pursuit of a "wealth effect" to stimulate the economy backfired. "Unprecedented inequality is clear proof that the wealth effect is all too effective for the wealthy, but an accelerant to economic hardship for everyone else."*

Former Kansas City Fed President **Thomas Hoenig:** *"The Fed's policies shifted money between the rich and the poor, and they encouraged or discouraged things like Wall Street speculation that could lead to ruinous financial crashes."*

extent that they do increase consumption, the effects may reverse once discount rates are normalized.

In Petrou's view, the exacerbation of income and wealth inequality is a function of the distribution of assets in the United States—which the Fed should take as a given. Only the very wealthiest individuals own financial assets that are most directly impacted by the Fed's large-scale asset purchases. Moving down the spectrum, a substantial portion of the middle of the income distribution has exposure to home equity, but this asset is less sensitive to the Fed's financial market machinations. The bottom 50 percent of the income distribution, however, has very little net wealth, "derived mostly from automobiles, not from other durable or financial assets that hold or gain value over time." As a result, the natural consequence of the Fed pursuing the wealth effect is actually to compound the wealth of the most fortunate members of our society.

Additionally, Petrou points out that the Fed's habit of riding to the rescue of financial asset owners has effectively corrupted the disciplining role that financial markets are supposed to play in the economy. As a result of successive Fed interventions, Petrou noted that one famous investor wrote, "Financial markets have come to expect the Fed to intervene in response to any sharp declines in equity prices." This situation, wrote another commentator, effectively set up a situation of "socialism for investors, capitalism for everyone else."

In his book *The Lords of Easy Money: How the Federal Reserve Broke the American Economy* (2022), journalist Christopher Leonard details the rich history of the personalities and meetings that drove the expansion of the Fed's toolkit. In particular, he documents former Kansas City Fed President Thomas Hoenig's famous 2010 dissent from the Fed's decision to begin a formal program of asset purchases targeted not at financial stability, but as a tool of monetary policy, which subsequently became known as QE. Hoenig has historically eschewed partisan identification—he was chosen as vice chair of the Federal Deposit Insurance Corporation to fill a Republican seat and formally nominated by President Obama—and is identified with the "hawkish" wing of monetary policy practitioners.

Yet Hoenig's prescient objections to QE centered not on the threat of inflation, but on what he termed the "allocative effect" of the Fed's policies. To Hoenig, "the Fed's policies did a lot more than just affect overall economic growth. The Fed's policies shifted money between the rich and the poor, and they encouraged or discouraged things like Wall Street speculation that could lead to ruinous financial crashes." Hoenig's warnings would play out over the next decade, as financial assets soared with little flow through to the real economy.

Hoenig's career also highlights a commitment to sound long-term economic thinking, which sometimes ran into the short-term exigency that drove much of the decision-making around QE. In his 1991 job interview with Fed Chairman Alan Greenspan for the position of Kansas City Fed president, Hoenig argued that "monetary policy needed to be made with restraint, and a long-term view … [because] every action you take has long-run consequences." Evidently Greenspan agreed at the time, as he subsequently approved Hoenig's hiring. But under the exigency of short-term economic pressure, Greenspan forgot this message, causing Hoenig to dissent from a 2001 decision to again cut rates at the tail end of the 2001 easing cycle, as Hoenig argued that the FOMC should take more time to evaluate the effects of its prior actions before cutting further. The subsequent asset bubble stemming from the Fed's easy money policies in the early 2000s contributed to the buildup of risk in the financial system that ultimately led to the 2008 financial crisis.

Only the very wealthiest individuals own financial assets that are most directly impacted by the Fed's large-scale asset purchases.

The pressure to be seen to be "doing something" can become all-encompassing for policymakers, leading to decisions like the start of QE. Fed Chair Bernanke used this rationalization to argue for QE at the FOMC. "This is very, very difficult … we don't have good options. It feels safer not to do anything, but then, on the other side, we have an economy which is underperforming very severely…. So there's no safe option." Predictably, Bernanke titled his 2015 memoir *The Courage to Act*, leaving no doubt that he wished to be known as a great pioneer who pushed the boundaries rather than as a deliberative caretaker who humbly executed his limited mandate.

—S. Bessent

triggered by the $2.1 trillion American Rescue Plan of 2021 would be “transitory.” Some price pressures did prove temporary, but the FOMC ultimately had to tighten far more than it had anticipated.

At the end of 2021—despite clear signs of accelerating inflation—the Fed projected year-end federal funds rates of 0.9 percent for 2022, 1.6 percent for 2023, and 2.1 percent for 2024. Even in June 2022, with inflation in full swing, the Fed forecast a peak rate of 3.8 percent at the end of 2023, followed by a decline. In reality, the rate has remained above 4 percent since December 2022.

The Fed’s failure to anticipate the inflation surge stemmed from flawed models. A straightforward application of the principles of supply and demand signaled trouble. Many observers noted at the time that the fiscal jolt was far larger than the estimated output gap. Nevertheless, the Fed—breaking with its tradition of political neutrality—publicly called for the stimulus and then accommodated it with ultra-loose monetary policy.

The Fed’s erroneous models of the economy also relied on a fundamentally false and self-reinforcing assumption: that inflation is primarily determined by inflation expectations, which are, in turn, influenced by the Fed’s own communication and credibility. In other words, the Fed believed that simply signaling its commitment to low inflation would be enough to maintain price stability. Former Bank of England Governor Mervyn King has aptly described this approach as the King Canute theory of inflation, drawing an analogy to the medieval king who was thought to command the tides. As Governor King put it, “A satisfactory theory of inflation cannot take the form, ‘inflation will remain low just because we say it will’.”

Economic models do not have political biases. But they are based on certain beliefs about how the economy works, which may in turn be correlated with various political views. The FOMC has consistently overestimated its own power in stimulating real growth and in controlling inflation. It has overestimated the efficacy of spending-based fiscal policy and underestimated the efficacy of tax cuts and deregulation. In sum, the biases in its model have the same political tilt that has plagued most of Washington for decades: we know better than the market.

Buoyed by its perceived success in combating the financial crisis, the Fed extended its liquidity tools into uncharted territory.

In addition to its misguided reliance on flawed models, the Fed’s unconventional monetary tools disrupted an essential source of feedback: the financial markets. The wall of liquidity created by QE flattened the cost of capital across industries and sectors, effectively drowning out the market’s ability to send early warning signals when the real economy shows signs of weakening or of rising inflation. In normal conditions, financial markets would have served as a barometer for potential risks to the economic outlook. Instead, the distortions caused by the Fed’s actions prevented these signals from emerging in a timely fashion.

MONETARY CONTAGION HITS THE REAL ECONOMY

Despite the Fed’s limited understanding of the relationship between gain-of-function monetary policy and real economic output, one outcome is unequivocal: severe distributional consequences across American society. These repercussions first became apparent during the 2008 financial crisis. According to Bagehot’s classic model, the central bank’s function in such situations is to engage in emergency lending at a penalty rate to ensure that liquidity operations do not paper over deeper solvency issues and to prevent fraud.

The Rich Got Richer

Successive interventions by the Fed during and after the financial crisis created what amounted to a *de facto* backstop for asset owners. This led to a harmful cycle whereby asset owners came to control an ever-larger portion of national wealth. And within the class of asset owners, the Fed effectively chose winners and losers by expanding asset purchase programs beyond Treasuries to private obligations, with the housing sector receiving particularly favorable treatment.

The impact of these policies extended far beyond the asset owners directly benefiting from QE. Within the corporate sector, the Fed’s interventions provided a distinct advantage to large companies, often at the expense of smaller firms.

—S. Bessent

Institutional Growth at All Costs

The Federal Reserve does not merely have an enormous footprint in financial markets. It also has an immense footprint in its operations and budget. Recent decades have seen the Fed grow into an ever-larger organization. Crucially, this raises important issues of democratic accountability because the Fed is not funded by appropriations from Congress. Instead, it is funded out of earnings on its securities portfolio, or in the absence of such earnings, by printing money.

The system of Reserve Banks has always been relatively large given the manpower-intensive supervisory operations. In 1995, the Reserve Banks had 23,536 employees, which actually decreased to 20,733 employees in 2023. Over the same time period, the budget for personnel expenses at the Reserve Banks grew from $968 million to $4,275 million, significantly outpacing overall U.S. wage growth, which roughly tripled in nominal terms during this period. This suggests taxpayers have incurred outsized compensation costs at the Reserve Banks over time.

In contrast, the Washington, D.C.-based Board of Governors has grown much more dramatically. In 1995, the total annual budget of the Board of Governors was $167 million. By 2023, the Board of Governors' budget grew to $989 million. The Board of Governors had 2,990 employees in 2023, up from 1,704 in 1995. Unsurprisingly, the increased allocation of resources to the Board of Governors has coincided with the increased dominance of the Board of Governors of the monetary policy process, with dissents from Reserve Bank governors becoming increasingly rare.

The Fed also has its own police force—the Federal Reserve Police. Perhaps unsurprisingly, the Federal Reserve Police has no website, and the Fed discloses little information about its operations, though its primary function is focused on securing Fed facilities. Presumably the Fed downplays its police force because increased public awareness could raise questions about the need for taxpayers to underwrite it, particularly since this force is not appropriated by Congress under the typical process for spending decisions.

The Fed has its own police force.

The Fed's major renovations of the Martin, Eccles, and 1951 Constitution Avenue buildings have also attracted significant attention. In particular, the Eccles and 1951 Constitution Avenue projects resulted in significant cost overruns. In November 2018, the Fed budgeted $75 million to begin renovation for these two building. It budgeted another $1.4 billion in January 2020 for the "revitalization" of these two buildings. The figure became $1.9 billion in November 2022 and landed at $2.5 billion in December 2024.

As the Fed deployed its unconventional monetary policy tools, its balance sheet has swollen over time, also without any authorization from Congress. Prior to the 2008 financial crisis, the Fed's balance sheet was modestly sized at approximately $900 billion, with liabilities consisting almost entirely of currency in circulation. However, successive QE programs swelled the balance sheet to $4.5 trillion by the end of 2014, where it held until the abortive attempt to reduce the size of the balance sheet in 2018.

The Fed is not funded by appropriations from Congress. Instead, it is funded out of earnings on its securities portfolio, or in the absence of such earnings, by printing money.

The Fed added another $3 trillion to its balance sheet in just three months during the covid pandemic, including a massive mortgage-backed securities buying program that continued while home prices skyrocketed by 40–50 percent in many markets. The Fed progressively grew its balance sheet to almost $9 trillion even amid the 2021 inflation surge. Today, the balance sheet sits at approximately $7 trillion, with the steady-state size unclear. But what is clear is that whatever the size of the steady-state balance sheet, the Fed will have effectively monetized an amount of Federal debt equal to the increase between the terminal balance sheet and the 2008 balance sheet.

The Fed's massive balance sheet expansion during a period of low interest rates has also resulted in significant losses for taxpayers in today's higher-interest-rate environment. This is because the interest rate the Fed pays on its liabilities to the private sector is higher than the yield at which it purchased its securities portfolio. The Fed is currently running annual losses of more than $100 billion, which will continue as long as short-term interest rates remain elevated. This could turn the Fed's unrealized losses of approximately $750 billion–$1 trillion into actual losses, which the Fed would also be forced to realize if it deliberately shrunk its balance sheet rather than allowing passive run-off via maturities. The procyclical budget dynamics of QE are yet another under-researched, rarely discussed aspect of gain-of-function monetary policy.

—S. Bessent

However, successive interventions by the Fed during and after the financial crisis created what amounted to a *de facto* backstop for asset owners. This led to a harmful cycle whereby asset owners came to control an ever-larger portion of national wealth. And within the class of asset owners, the Fed effectively chose winners and losers by expanding asset purchase programs beyond Treasuries to private obligations, with the housing sector receiving particularly favorable treatment.

The impact of these policies extended far beyond the asset owners directly benefiting from QE. Within the corporate sector, the Fed's interventions provided a distinct advantage to large companies, often at the expense of smaller firms. Larger corporations with access to debt capital markets were able to take advantage of historically low interest rates by terming out their debt at fixed rates. In contrast, smaller companies, which tend to rely on floating-rate bank loans, found themselves squeezed by rising borrowing costs as the Fed was forced to raise interest rates in 2022.

Even more damaging were the distributional effects of gain-of-function monetary policy on households, which have strained the social fabric of the United States. The Fed's actions along the risk and time curves compressed interest rates, driving up the prices of assets. This mechanism disproportionately benefited those who already owned assets. Homeowners, for example, saw the value of their properties soar. They were mostly shielded from the effects of rising interest rates given the structure of the U.S.

The Fed's adoption of unconventional tools during the 2010s pushed the effective nominal interest rate to as low as -3 percent by May 2014.

housing market, where over 90 percent of all mortgages are fixed-rate. As a result, the housing market remained overheated even as interest rates rose, with over 70 percent of existing mortgages carrying rates more than three percentage points below the prevailing market rate.

At the same time, less well-off households, shut out of homeownership by rising interest rates, missed out on

The Fed—breaking with its tradition of political neutrality—publicly called for the stimulus and then accommodated it with ultra-loose monetary policy.

the asset appreciation that benefited wealthier households. These households also faced tighter financial conditions as higher interest rates drove up the cost of borrowing. Meanwhile, inflation—partially fueled by the Fed's massive expansion of the monetary base through QE and the associated accommodation of record fiscal spending—disproportionately affected lower-income Americans, further exacerbating economic inequality. And it put homeownership out of reach for a generation of young Americans. By failing to deliver on its inflation mandate, the Fed allowed class and generational disparities to worsen.

UNCONVENTIONAL MONETARY POLICY THREATENS THE HEALTH OF THE BODY POLITIC

The Fed's growing footprint also has profound implications for the political economy, placing its valuable independence in a precarious position. By extending its remit into areas traditionally reserved for fiscal authorities, the Fed has blurred the lines between monetary and fiscal policy. This is particularly evident in the Fed's balance sheet policies, which affect the allocation of credit across the economy. When the Fed acquires non-federal government obligations, it directly influences which sectors receive capital, thereby intervening in what should be the domain of the capital markets and fiscal authorities.

Moreover, the Fed's foray into the Treasury markets has drawn it into the realm of public debt management, a role traditionally overseen by the Treasury Department. This entanglement between the Fed and the Treasury is concerning, as it creates the perception that monetary policy is being used to accommodate fiscal needs, rather than being deployed solely to maintain price stability and promote maximum employment.

The Fed's expanded toolkit also had broader consequences for the behavior of elected officials. The Fed's actions fostered a culture amongst the old Washington establishment that encouraged reliance on the central bank to bail out poor fiscal policies. Instead of taking responsibility for fiscal decisions, past administrations and Congresses expected the Fed to intervene when their policies led to economic dysfunction. The "central banks are the only game in town" dynamic created perverse incentives for fiscal irresponsibility, as the costs of poor governance were increasingly deferred or masked by the Fed's monetary interventions.

Even in June 2022, with inflation in full swing, the Fed forecast a peak rate of 3.8 percent at the end of 2023, followed by a decline. In reality, the rate has remained above 4 percent since December 2022.

At the heart of these concerns is the erosion of central bank independence, which is a cornerstone of sustainable economic growth and stability. As the Fed expanded its remit, it eroded the traditional boundaries that insulated it from political influence. Critics who argue that the Fed has overstepped its role by engaging in fiscal or quasi-fiscal activities are correct.

The Fed's missteps and policymaking arrogance have placed its credibility at risk, jeopardizing its independence on its core responsibility of monetary policy. The overestimation of the power of oneself or one's institution is a fundamentally human trait. In certain cases, it can even be productive. But it is highly problematic for the conduct of monetary policy. The Fed alleges that it needs to be independent. But is it? Or is it captive to the ghosts of its past and of its own ego? Monetary policy helped create the housing bubble, and slow recognition by the Fed and others of the warning signs worsened the financial crash. Despite its culpability, the Fed emerged from the financial crisis with more powers than it had going in. Alas, these expanded powers and a lack of humility have only further added to the Fed's missteps.

REGULATORY OVERREACH, CONFLICTS OF INTEREST, AND THREATS TO INDEPENDENCE

Congress's post-crisis reforms dramatically enlarged the Federal Reserve's supervisory footprint. The 2010 Dodd-Frank Act placed every bank holding company with more than $50 billion in assets (later $100 billion, subject to discretion) under Fed supervision, empowered it to designate and regulate systemically important non-banks, mandated annual stress tests and living will reviews, and made it the primary overseer of key clearinghouses and payment utilities. The abolition of the Office of Thrift Supervision folded thrift holding company oversight into the Fed as well. Layered on top of Basel III capital and liquidity rules the Fed itself writes, these changes transformed the central bank from lender of last resort into the dominant microprudential regulator of U.S. finance.

Fifteen years on, the results are disappointing. The 2023 failures of Silicon Valley Bank, Signature Bank, and First Republic all occurred at firms subject to Fed exams and bespoke stress tests. Supervisors flagged vulnerabilities but failed to escalate; the same staff who craft monetary policy briefs missed plain-vanilla duration risk. Earlier scandals—from Wells Fargo's sales practice abuses to JPMorgan's "London Whale"—likewise metastasized under the Fed's watch.

The core problem is structural: the Fed now regulates, lends to, and sets the profitability calculus for the very banks it oversees. This is an unavoidable conflict that blurs accountability and jeopardizes monetary policy independence.

The Fed's unconventional monetary tools disrupted an essential source of feedback: the financial markets.

That conflict feeds back into policy. A Fed worried about exposing its own supervisory failures has a direct incentive to keep liquidity abundant and rates low, lest asset values fall and banks stumble. Conversely, an aggressive anti-inflation stance forces the Fed to admit those failures when tighter policy reveals weak balance sheets. Either way, monetary policy becomes hostage to supervisory self-interest.

Continued on page 68

Continued from page 23

A more coherent framework would restore institutional specialization. The Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency have decades-long expertise in examiner-led, rules-based bank supervision. Day-to-day safety and soundness exams, consumer protection enforcement, and prompt corrective action powers should reside with those agencies, leaving the Fed to focus on macro prudential surveillance, lender-of-last-resort liquidity, and the traditional tasks of monetary policy.

By failing to deliver on its inflation mandate, the Fed allowed class and generational disparities to worsen.

Re-empowering the FDIC and OCC would sharpen accountability, rebuild the firewall between supervision and monetary policy, and help safeguard the Fed's independence while improving bank safety.

THE FED'S NON-PARTISAN STATUS BECOMES QUESTIONABLE

The Fed must also address the perception that it has become increasingly partisan in recent years. Research from the Manhattan Institute reveals a troubling shift in the political composition of Reserve Bank directors. Between 2010 and 2015, the proportion of Reserve Bank directors who made political donations was roughly balanced between political parties, with approximately 20 percent contributing to Republicans and 20 percent to Democrats. However, since 2015, the share of directors donating to Republicans has plummeted to 5 percent, while the share donating to Democrats has risen to 35 percent. This shift has fueled concerns that the Fed is becoming a partisan institution, undermining its neutrality and independence. Compounding this problem is the Fed's strategic engagement with the press, including by providing preferential access based on the tone and content of reporting. By using the press as a tool to advance its interests, the Fed has created the perception that it is attempting to shield itself from good-faith oversight. This behavior has weakened its accountability and further eroded trust in the institution.

Regulatory and monetary policy is best left to a politically independent institution. But that institution must also be accountable. Mature and responsible individuals hold themselves accountable to themselves first and foremost. Naturally that is a challenge, as we all possess egos. Holding oneself to account should be easier for an institution because it theoretically lacks a psyche and ego. But institutional self-interest plays the same role. The evidence at the Fed is clear, particularly since its adoption of gain-of-function monetary policy. The Fed has become beholden to its institutional self-interest at the expense of the national interest. It has not objectively assessed its performance and adjusted its processes accordingly.

The Fed continues to avoid accountability because any criticism of its performance is met with a chorus of media voices calling legitimate criticism an attack on central bank independence. The Fed should be able to conduct its policy free of political pressures. Monetary policy should not be made in the White House or on Capitol Hill. But when the Fed's monetary policy produces suboptimal results, it becomes the obligation of the elected leaders of our country to point out the Fed's shortfalls.

CONCLUSION

The Federal Reserve's heavy intervention in financial markets over recent decades has led to a series of unintended consequences. While these unconventional tools were introduced to address extraordinary circumstances, their efficacy in stimulating economic activity remains unclear. But they have clearly produced severe distributional outcomes across American society, undermined the Fed's credibility, and threatened its independence.

At the heart of the Fed's independence lies its credibility and political legitimacy. Both of these tenets have been jeopardized by the Fed's decision to expand its role beyond its traditional mandate and engage in what amounts to gain-of-function monetary policy. These actions have eroded the institution's insulation from political pressure, risking its ability to function as an independent entity.

Looking ahead, it is essential the Fed commit to scaling back its distortionary impact on markets. At a minimum, this likely includes the Fed only using, and then halting, unconventional policies like QE in true emergencies and in coordination with the rest of government. It also likely requires an honest, independent, and nonpartisan review of the entire institution and all of its activities, including monetary policy, regulatory policy, communications, staffing, and research. We now face not only short- and medium-term economic challenges but also the potentially dire long-term consequences of a central bank that has placed its own independence in jeopardy. To safeguard its future and the stability of the U.S. economy, the Fed must reestablish its credibility as an independent institution focused solely on its statutory mandate of maximum employment, stable prices, and moderate long-term interest rates. ◆