

On the Subject of Central Bank Independence



U.S. Treasury Secretary
Scott Bessent

*TIE asked U.S. Treasury Secretary Scott Bessent
to expand on his views about the Fed's role.*

TIE: In a recent statement, you called for a review of the Federal Reserve, specifically its non-monetary operations due to mission creep and an overwhelming bureaucracy. Can you explain when you began to have these worries of overreach?

Bessent: As laid out by the Federal Reserve Act, Fed's primary focus should be on its monetary policy mandate of maximum employment, stable prices, and moderate long-term interest rates. In the last decade and a half, the Fed decided to expand its remit—inserting itself into contentious social and political debates. It most notably started with the 2010 Dodd-Frank Act, which significantly expanded the Fed's regulatory and supervisory powers. The Fed began to experiment in areas like climate change.

And even on its core mandate of monetary policy, it opened the aperture to consider policy issues that are better left to other parts of government. In 2020, the Fed revamped its monetary policy framework to consider “broad-based and inclusive” maximum employment—the Fed gave itself room to make political judgments with its monetary policy tools.

Whether intended or not, the Federal Reserve's decision to engage in political activity provoked legitimate criticism that undermines its ability to retain independence on its core mission of monetary policy. As a first step, I have called for a comprehensive internal review.

TIE: But Dodd-Frank was passed into law during a time of incredible job loss due to an over-leveraged banking system and housing market. Can one not argue that Dodd-Frank was a necessary evil?

Bessent: Crises, rightly or wrongly, often provoke regulatory blitzes aimed at fixing problems of the past, while fully neglecting unforeseen consequences. The Dodd-Frank Act placed every bank holding company with more than \$50 billion in assets under Fed supervision and expanded the scope of the Fed's authorities with respect to regulated institutions. These changes transformed the central bank from lender of last resort into the dominant micro-prudential regulator of U.S. finance.

Fifteen years on, the results are disappointing. The 2023 failure of Silicon Valley Bank is illustrative. Supervisors flagged vulnerabilities, but failed to escalate.

The core problem is structural: the Fed now regulates, lends to, and sets the profitability calculus for the very banks it oversees. Supervisory responsibilities sometimes conflict with monetary policy. Empowering the Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency would sharpen accountability, rebuild the firewall between supervision and monetary policy, and help safeguard the Fed's independence.

TIE: So, the Fed took itself into the political arena, which to a degree sacrificed its objectivity and thus its independence. From your perspective, as an experienced investor and economic historian, why do you value the monetary policy independence in the first place?

Bessent: Central bank independence is the cornerstone of sustainable economic growth and stability. Forward inflation expectations declined considerably in the

appropriately discount the distribution of future paths. That is, if the Fed can be counted on to make monetary policy decisions based only on knowable economic data,

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and not external political whims, then the markets will remain confident that price levels will be stable.

The central bank's independence underlies apolitical, objective decision making, in a well-defined policy lane. To safeguard its future and the stability of the U.S. economy, the Fed must reestablish its credibility as an independent institution and approach its mission from a position of humility.

TIE: Since the 2008 global financial crisis, the Federal Reserve has a less than sterling record of forecasting economic growth and inflation, which makes monetary policy decisions especially difficult. Given your experience as a macro investor, how do you think the Federal Reserve should approach the obvious uncertainty in projecting economic growth and how should this determine their tools such as forward guidance?

Bessent: Given their legions of economists, one would think the Federal Open Market Committee has great visibility into the economy's direction of travel. Unfortunately, the opposite is true. For example, in the past fifteen years (excluding 2020 and 2021 because of covid), real GDP growth averaged 2 percent annually. The FOMC's average two-year forward forecasting error was 1.1 percent, or 58 percent of that figure.

It would've been more accurate for the FOMC to just guess the average at the onset in 2007. FOMC members and their staff added a negative net value for forecasting the next year's growth.

And when it really counted, the FOMC missed badly. From 2010 to 2016, the Fed's two-year forward projections overstated real GDP by 7.6 percent. After covid, the Fed forecast PCE inflation in 2021 to be 1.8 percent. In fact, PCE inflation turned out to be 4 percentage points higher, at 6 percent.

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United Kingdom when the setting of the base rate, their overnight benchmark, was moved from H.M. Treasury to the Bank of England. Transparency and clarity in the Fed's so-called "reaction function" to economic inputs allows the markets to price today's economic risks and

The Fed places too much faith in its own abilities, flawed models, and a simple neglect for principles of supply and demand. The lack the humility makes for an especially risky approach to risk management.

The *Summary of Economic Projections* (SEP) is an embarrassment and should be ended. One of my most successful private sector trading strategies was taking the opposite position of the SEP.

TIE: Large-scale asset purchases were used as an emergency tool for the largest economic shock since the Great Depression, but since, quantitative easing has been “normalized” for all developed-market central banks. While one could argue QE was instrumental in diminishing the effects of the global financial crisis, how do you see the usage of this policy tool as it has become more regular?

Bessent: Quantitative easing is a relatively new experiment—with uncertain costs and benefits. One major problem is that since the Fed embarked on QE, there has been little serious cost-benefit analysis presented to Congress.

It is the continual use of QE that is problematic. It defied all logic to continue QE until the month before rate hikes began in March 2022. QE flattened the cost of capital across industries and sectors, effectively drowning out the market’s ability to send signals for changing growth or

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inflation. In normal conditions, financial markets should serve as a barometer for risks to the economic outlook. QE suppresses these signals.

Take, for example, the post-covid era. The Fed’s balance sheet operations both fueled an inflationary expansion of the money supply and suppressed important market signals on potential risks associated with inflation. Common sense would have urged the Fed to stop. But due to groupthink, there were no FOMC dissents during this time.

All of this shows that in a world where the Fed uses QE regularly, there needs to be a plan to manage those conflicts, and there doesn’t appear to be one. And the academic and empirical data on QE and quantitative tighten-

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ing are not robust. QE is inherently fiscal and political in nature. It chooses winners and losers. For this reason, there should be a whole-of-government approach to establishing its use.

TIE: In the last decade and a half, the United States has experienced stellar investment performance as measured by equity prices, real estate prices, and credit spreads. At the same time, the United States is dealing with increasing income/wealth inequality and falling homeownership. How should the Federal Reserve view these conflicting measures of success as it designs monetary policy going forward?

Bessent: Let me begin by saying that the Fed’s job is to focus on its statutory mandate, whereas distributional policies are the domain of Congress and the rest of the executive branch. When the Fed tries to use monetary policy to pursue political agendas, it puts its independence at risk.

But paradoxically, the Fed’s expansion of monetary policy tools beyond its original decision have had extremely harmful distributional effects.

The Fed’s actions disproportionately benefited those who already owned assets, while less-well-off or younger households missed out on the asset appreciation that benefited wealthier households. After the Covid-19 pandemic, working-class households faced higher interest rates and higher inflation, both a result of the Fed’s actions and inaction.

My advice would be to not attempt to clean up the mess, but instead go back to the basics on monetary policy.

TIE: During the first period of growth of the Fed's balance sheet, the Fed was able to remit earnings back to Treasury. However, in recent years, as the interest on short-term liabilities has increased compared to the interest on long-term assets, the Fed has been accumulating losses, marked as a "deferred asset." How should these losses factor into the decision-making of the Federal Reserve and the U.S. government? And is this earnings risk appropriate for the long term?

Bessent: The Fed is supposed to make money—and when its balance sheet was small and monetary policy straightforward, it always did. From 1960 to 2008, the Fed's remittances ranged from about 0.2 percent to 0.4 percent of nominal GDP. Those earnings belong to the taxpayer and were remitted to Treasury.

In the wake of the global financial crisis, the Fed's remittances increased sharply to around 0.5 percent of GDP from 2009 to 2015 before subsiding back to more normal levels. The Fed's net earnings were boosted by the differential between the yields accruing on its securities holdings versus the interest rate paid on its reserves.

That pattern has been reversed more recently given the rapid increase in front-end yields, and the Fed is now losing around \$100 billion per year. These losses, which are ultimately a drag to the taxpayer, have never been a part of an external or congressional review.

Today, the Fed likely does need a mechanism to pay interest on reserves to maintain some amount of control over

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short-term rates. However, they should consider budgetary effects when they embark on any unconventional tool, QE included. Perhaps we should consider a long amortization period for these losses. Perhaps the Fed should pay the Treasury interest on the Treasury General Account.

TIE: We have established that the Fed has inappropriately expanded its monetary authority, wading into areas in which it has caused more issues than gains. But how do you think about the Federal Reserve's budget in the

context of operating expenses? You even said that the Fed is like universal basic income for economists.

Bessent: You raise an important issue because the Fed is not funded by appropriations from Congress, but does

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take budgetary risks. And with the expansion of influence in financial markets, the Fed has built an immense footprint in its operations and budget. In the last three decades, the budget for personnel expenses at the Reserve Banks grew from \$968 million to \$4,275 million, significantly outpacing national wage gains. The Board of Governors' budget grew more dramatically, from \$167 million to \$989 million, coinciding with the increased dominance of the Board of Governors in the monetary policy process. Then, of course, there is the well-known cost overrun of the Fed's renovation.

The massive growth in operations has done little to increase the Fed's forecasting accuracy and has likely led to worse monetary policy decisions. Some honest reflection on waste, fraud, and abuse is warranted. This is what happens when you have a lack of oversight. Here at Treasury, we run a tight ship on expenses.

TIE: So where does that leave us?

Bessent: The Fed must change course. Its toolkit has become too complex to manage. Gain-of-function monetary policy must be replaced with simple and measurable policy tools. This will safeguard central bank independence over time.

It requires an honest review of the entire institution. The Fed's actions have provoked justifiable criticism that placed its independence at risk. In order to safeguard its independence and the stability of the U.S. economy, the Fed must reestablish its credibility as an independent institution whose economic decisions serve the public interest.

I expect an answer on the internal review that I've called for. Good stewardship is earned, not jawboned. ♦