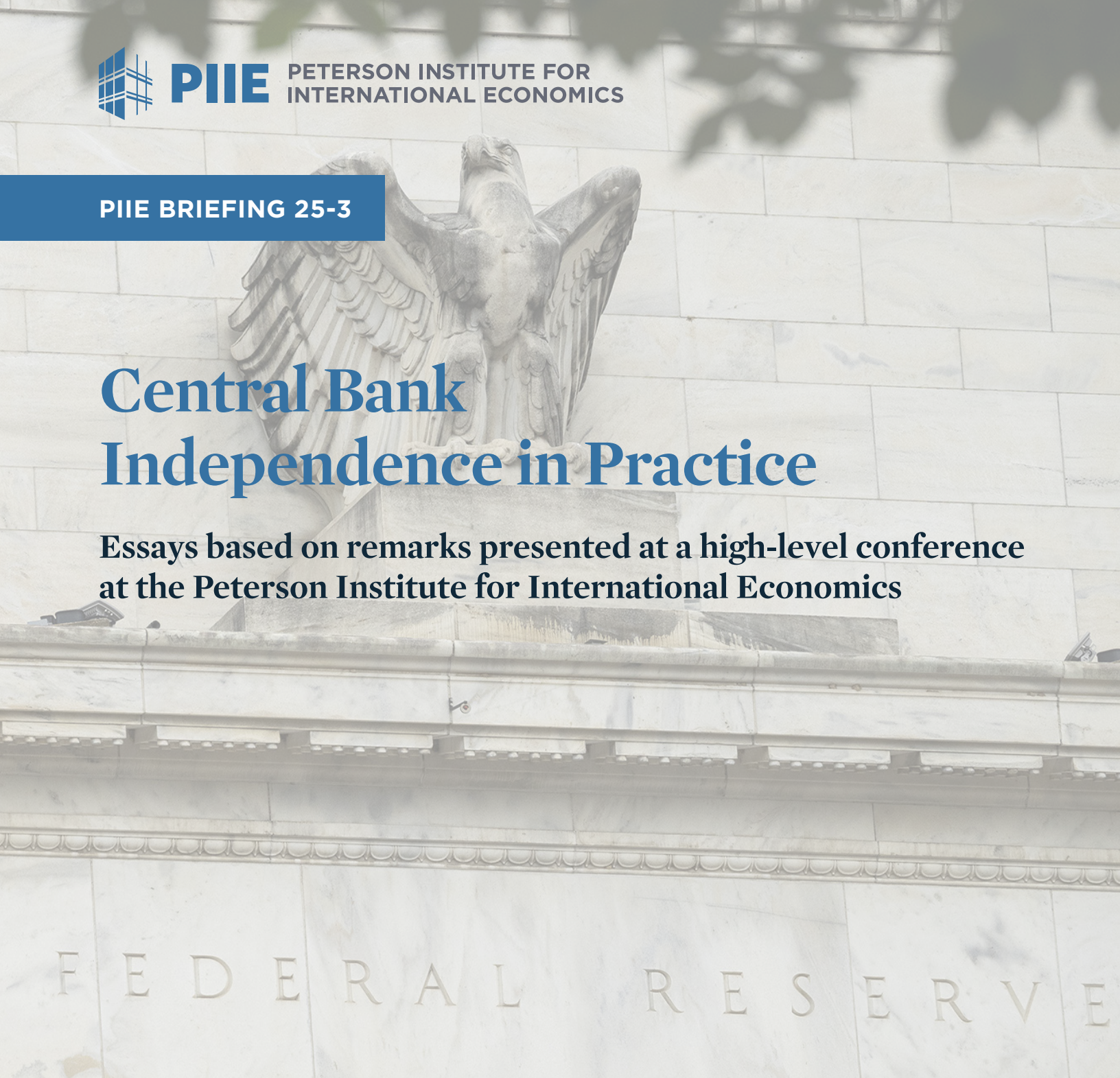


PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

PIIE BRIEFING 25-3

Central Bank Independence in Practice

Essays based on remarks presented at a high-level conference at the Peterson Institute for International Economics

John H. Cochrane, Adam S. Posen, and David Wilcox, editors

December 2025

1750 Massachusetts Avenue, NW | Washington, DC 20036-1903 USA | +1.202.328.9000 | www.piie.com

Contents

Cover photo: Sipa USA/Graeme Sloan

Introduction: What Central Bank Independence Means and Raises

ADAM S. POSEN

Adam S. Posen is the president of the Peterson Institute for International Economics.

Central bank independence in practice is a very high stakes issue. It has recently become a salient issue politically as well in the United States—the latest recurrence of historical debates over the power and legitimacy of a central bank here. And, as with some other newly controversial policy regimes once taken for granted—like vaccinations or combating climate change, where there was an intellectually solid scientific or technocratic agreement—there suddenly is a lot of controversy. I believe that part of the reason for this public doubt is broader social and political forces opposed to authority by expertise. This goes beyond the economic realm but is fueled for the Federal Reserve in part by the justified perceptions of massive economic policy failures in recent years, including the North Atlantic financial crisis of 2008–2012 and the inflation surge accompanying the COVID-19 pandemic in 2020–2021.

I also believe central bank independence is now controversial in the United States because independence is such a big word. People hear independence and they think of the Declaration of Independence and some politicized MAGA imagery. They think of principles for the executive branch's power and role. But as Stanley Fischer and Guy Debelle (1995) pointed out 30 years ago, what we are talking about with respect to the Fed is much less grand: instrument or operational independence, not goal independence. In other words, no one is advocating that the Fed should be able to do whatever it wants to do, and no one serious ever did. Elected officials, Congress in the US system, must set the Fed's policy goals.

The discussion in practice is about how much, and in what ways, the Fed is given autonomy to do what it needs to do to pursue the goals set by Congress. One could make an analogy that central bank independence is treating a monetary policymaker like a surgeon or an airline pilot. The patient or passenger must leave them to do their work and then they and their advocates should evaluate performance on the basis of results ex post—God forbid there was a crash or a surgical error. The problem is, of course, that inherently there are going to be some mistakes. In fact, because the central bank deals with the macroeconomy, rather than working in an airplane cockpit or an operating room, the central bank inherently has far less control.

Furthermore, if having a well-meaning amateur, let alone a politically motivated opportunist, interfere in the cockpit or operating theatre is more likely to cause additional crashes and mistakes than to prevent them, so will outcomes be worse for amateurs than professionals in central banks. Ironically and realistically, based on Kenneth Rogoff's (1985) insight 40 years ago, the

power of expectations makes operational independence even more important for monetary policymaking. If you distrust your surgeon or your pilot, or just irrationally have a fear of flying, in the end that has no effect on whether the plane reaches your destination or the surgery goes well. If there is ongoing distrust of monetary policymakers' commitment to low inflation, though, then inflation rises whether or not the central bank is doing the right thing. You end up worse off and get no benefit in terms of output growth or employment. This is the dreaded condition of "unanchored inflation expectations" that current day central bankers are always concerned about.

So, the empirical research on central bank independence that we all built on through the years was always about specific observable institutional aspects over time, starting with Alesina and Summers (1993) and Cukierman, Webb, and Neyapti (1992), followed by many others. I was one of the early contributors to this literature, and it has been updated right up through latest data and methods (including by contributors to this PIIE Briefing). The result of these dozens of papers across decades of research is clear, consistent, and sensible. The very overt politicization of the Fed or of any central bank raises average inflation rates, with no net gain in economic growth once the needed disinflation that follows is taken into account, as well as the lasting impact of increasing inflation persistence.

That literature tells us what matters in practice in terms of specific pressures on central bank independence, not just ideal types of monetary institutions. It is very clear in the data that if you allow politicians to make monetary policymakers juice the economy right ahead of an election, or to force central banks to make direct purchases of government debt rather than do so by choice in the secondary market, or to change the leadership of the central bank frequently on a political basis before terms expire, any of those measures directly raises inflation expectations and then inflation. We have seen this happen within the last ten years in Turkey and India, where the elected heads of government forcibly replaced the central bank governor repeatedly in quick succession, and this was associated with significant jumps in inflation in no time.

That evidence, though, is apparently not enough to settle the issue in the current public debate. There is good reason to examine the argument for independence and to make sure that it extends and applies in the current context, as it once did when distinguishing the stark differences in performance between the 1970s Deutsche Bundesbank and the Banca d'Italia, or the 1980s Federal Reserve and the Banco Central de la República Argentina.

One issue is that it simply is not enough to say, okay, rule out the really obvious political capture gambits. The debate is over how much should political preferences of appointees (and their appointers) be reflected in policy choices and communications? What should the central bank do when its leadership is aware that it behaves in a political context where the institution is at risk? How should it be accountable so that it does not just avoid overt partisanship or monetary financing of the government, but also is not interpreted as subject to excessive partisanship and thereby lose legitimacy to act?

A second key issue, going back to my own dissertation 30 years ago, is that declarations are not enough (Posen 1995). Legislators and central bank designers cannot just set it and forget it with an independent central bank. There has to be an effective political coalition in society that supports the Fed's independence,

or its independence will not be credible and will not last. That seems to be at risk today.

This was our purpose in convening a conference at the Peterson Institute: to contribute to the substantive, nonpartisan, evidence-based public debate on why, how, and in what specific ways should the Fed be kept operationally independent in pursuit of its mandated goals. We sought to go through the strengths and weaknesses of what should be the case to the public, to the courts, and to Congress on these issues.

And, so, rather than offer motherhood and apple pie reviews about keeping independence against overt politics, John Cochrane, David Wilcox, and I organized our conference around these themes:

- Do recent data provide evidence of the benefits of central bank independence consistent with past results?
- What should be the constitutional and legal extent of independence of the Federal Reserve as part of the broader legal framework?
- Does the current system of accountability, including the current ways of appointing the leaders of and overseeing Federal Reserve System banks, serve democratic accountability?
- How narrowly should independence be defined, in particular between banking supervision, financial intervention, and monetary policy?
- How have central bankers in practice coped with the pressures of politics and the pursuit of independent policy? Are there issues we missed with our research work?

This PIIE Briefing brings together revised and extended presentations from our high-level conference on central bank independence in practice, held in Washington on October 31, 2025. Video of the full conference is available for viewing on the PIIE website. As president of the Peterson Institute, I had the privilege of working with John Cochrane of the Hoover Institution and David Wilcox of PIIE to assemble the extremely substantively engaged group of authors on this topic.

For that reason, we brought together a broad range of contributors, including people from academia, both younger scholars with new research on central bank independence and older scholars who started some of the work in this field, as well as practitioners from the Fed and elsewhere who understand what independence really means in practice. We deliberately did not include political appointees or elected officials of either party in our roster of speakers. But in the spirit of openness, we invited every single current member of the Federal Open Market Committee (FOMC) to participate. Though none elected to join the formal program, understandably, we are grateful that some FOMC members did attend, and a couple did participate in the on-the-record discussions.

This analytical reconsideration was not because we believe in conspiracy theories about or recurrent major failures by the Fed, though of course there is room for scrutiny and improvement in Fed performance. It was because when there are serious policy matters at stake affecting the welfare of the American people as well as our economic understanding, it is important to try to deal with them in an objective fashion based on empirical evidence.

REFERENCES

Alesina, Alberto, and Lawrence H. Summers. 1993. Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence. *Journal of Money, Credit and Banking* 25, no. 2 (May): 151–162.

Cukierman, Alex, Steven B. Webb, and Bilin Neyapti. 1992. Measuring the Independence of Central Banks and Its Effect on Policy Outcomes. *World Bank Economic Review* 6, no. 3: 353–398.

Debelle, Guy, and Stanley Fischer. 1994. How Independent Should a Central Bank Be? Federal Reserve Bank of Boston Conference Series [Proceedings], volume 38: 195–225.

Posen, Adam S. 1995. Declarations Are Not Enough: Financial Sector Sources of Central Bank Independence. *NBER Macroeconomics Annual 1995*, volume 10. MIT Press.

Rogoff, Kenneth. 1985. The Optimal Degree of Commitment to an Intermediate Monetary Target. *Quarterly Journal of Economics* 100: 1169–89.

***

The Peterson Institute for International Economics has no partisan goal in publishing this research. Our objective is to educate policymakers and the public about the effects these policies would have on Americans and other people around the world.

I. Evidence on Independence

Why Is It Useful? How Does It Work?

FRANCESCO BIANCHI
JOHN H. COCHRANE
RANDALL S. KROSZNER

FRANCESCO BIANCHI

Francesco Bianchi is the Louis J. Maccini Professor of Economics at Johns Hopkins University and a coeditor of the *American Economic Journal: Macroeconomics*.

This topic is highly important. To appreciate its significance, we should recall the situation before central bank independence became part of the institutional framework. We can focus on inflation in OECD countries.

In the 1960s and 1970s, inflation was widespread and volatile. This was particularly true for emerging economies, but also for the United States. Inflation declined in the early 1980s for advanced economies and somewhat later, in the 1990s, for emerging-market economies.

Since then, we have experienced a prolonged period of low and stable inflation, interrupted only briefly during the pandemic. Compared with earlier decades, recent fluctuations are far less concerning, at least so far.

If we examine the same countries in terms of real interest rates, we find that during the 1960s and 1970s, rates were consistently low, often negative, at a time in which central banks should have been fighting inflation. Real rates increased sharply in the early 1980s for advanced economies and in the 1990s for emerging economies.

This suggests that the shift in inflation dynamics was partly due to central banks adopting a more aggressive stance against inflation, a change made possible by granting them independence in pursuing the goal of low and stable inflation.

It is natural to ask what might happen if central bank independence were to be lost once again. To put this into perspective, we must first clarify what is meant by central bank independence. David Wilcox has already mentioned some aspects of this concept.

An important question is: independence from what, and from whom? In the context of monetary policy, independence refers to an institutional arrangement that establishes an arm's-length separation between the fiscal authority and the central bank.

This does not imply that the central bank operates above any form of authority. Rather, independence means operational autonomy in pursuing objectives that are defined by elected officials. This structure reflects the principle that policy goals should be set by those who are ultimately accountable to the electorate.

Central bank independence can be considered a second-best solution. Ideally, monetary and fiscal authorities would cooperate seamlessly for the greater good. In practice, however, this coordination rarely works as intended.

Politicians tend to have a biased perspective on policymaking. They generally favor increased spending over restraint and are highly proactive in addressing

recessions. However, they are less inclined to implement measures that cool down an economic expansion.

Taken together, these tendencies create an inflationary bias unless the central bank has the autonomy to pursue price stability. In this sense, an independent central bank serves as a safeguard against fiscal excesses. Importantly, financial markets rely on this independence. It is not merely a matter of preference; it is about market confidence in the institutional framework.

This reasoning is widely accepted for emerging-market economies, but growing evidence suggests that similar dynamics occur in advanced economies as well. In earlier work with Cosmin Ilut of Duke University, we interpreted the shift in US inflation from the 1960s and 1970s to the early 1980s as a transition from a fiscally led policy mix to a monetarily led one.

That paper considered data up to 2008, but more recent research in Bianchi, Faccini, and Melosi (2023) also includes the global financial crisis and the COVID-19 pandemic. The paper focuses on isolating what we call "fiscal inflation," inflation that arises when the central bank implicitly or explicitly accommodates excessive fiscal spending. In slide 14 of my conference presentation, posted on the PIIE website, the red line in the chart represents actual inflation dynamics, while the black line shows what inflation would have been if only unfunded fiscal shocks had occurred. Unfunded fiscal shocks refer to spending not backed by future taxes.

The data reveal that fiscal inflation was high and rising during the 1960s and 1970s, following an explosive trajectory. Conditions began to shift toward the end of the 1970s, and fiscal inflation dropped sharply in the early 1980s. This change is often associated with the appointment of Paul Volcker as Federal Reserve chair in 1979, but it is also fair to acknowledge the role of President Ronald Reagan's election, which signaled a broader societal shift regarding acceptable levels of inflation and the size of government.

Fiscal inflation does not disappear entirely after the early 1980s disinflation. It typically rises after recessions, which can be viewed as part of stabilization policies where monetary and fiscal authorities cooperate to support recovery. In the postmillennial period, however, we observe an interesting pattern: fiscal inflation remains relatively elevated but appears to offset deflationary pressures.

Where do these deflationary forces originate? Our interpretation is that they stem from the increasing globalization of the US economy. This raises an important question: what would inflation have looked like after the financial crisis if globalization had not intensified? This question is particularly relevant today, as we simultaneously attempt to reduce global integration, reconsider central bank independence, and implement ambitious fiscal plans.

The pandemic offers a clear example of what might happen in the future. According to our model, a significant portion of the recent surge of the post-pandemic inflation can be attributed to unfunded fiscal spending. In my work with Robert Barro from Harvard, we argue that a similar pattern emerges for all OECD countries.

A second question is whether political pressure works and if it does, in which sense it does. A natural question arises: when politicians exert pressure on the Fed, does the pressure influence financial markets and the Fed's actual behavior? This is a complex issue, and understanding the mechanisms is essential.

President Trump provides a unique case study. To be clear, he was not the first president to pressure the Fed. What distinguishes his approach is the use of social media, which offers a precise way to measure market reactions through timestamped data from Twitter, now called X.

In Bianchi et al. (2023), we analyze the impact of President Trump's tweets on market expectations about future monetary policy. In slide 19 in my conference presentation, posted on the PIIE website, panel (a) on the left side shows the cumulative changes in federal funds futures; on the right side of the same panel, we can zoom in on specific tweets marked by vertical bars, with colors indicating different maturities—the red representing longer horizons. Following these tweets, futures prices exhibit discrete downward shifts, signaling that markets revised expectations for future interest rates. This suggests that market participants anticipated the Fed would adjust its policy in response to political pressure.

Examining actual policy behavior reveals a more nuanced picture. After Trump began criticizing the Fed, the institution paused rate hikes and eventually reversed course. While correlation does not imply causation, incorporating these tweets into a vector autoregression model indicates that part of the reversal was attributable to this pressure. The likely mechanism is indirect: the Federal Open Market Committee (FOMC) does not respond to presidential statements per se, but it monitors market expectations. If markets anticipate rate cuts, failing to act could disappoint investors, effectively creating a contractionary shock.

Extending the analysis to Trump's second term shows similar patterns. The analysis is shown in my conference presentation in slide 25, on the left side, posted on the PIIE website. The tweets continued to push market expectations downward, with stronger effects on longer horizons. However, when examining long-term yields and mortgage rates, changes are negligible. This implies that while short-term policy may respond to political pressure, the ultimate objective of reducing borrowing costs for households remains elusive. In fact, these rates often move in the opposite direction.

The explanation lies in credibility. Markets depend on central bank independence to anchor long-term inflation expectations. If credibility erodes, inflation risk premiums rise, pushing long-term rates higher. This dynamic is particularly relevant today, as inflation remains above target, unlike the period of Trump's first term when inflation was persistently below target.

Central bank independence is indispensable for maintaining low and stable inflation. The question is not whether central banks make mistakes, they obviously do, but whether replacing professional decisionmakers with political agents would improve outcomes. History suggests otherwise. While some political pressure is inevitable, institutional norms must be preserved. Political influence may lower short-term rates, but it cannot sustainably reduce long-term borrowing costs, which depend on credibility and expectations. If independence is compromised, long-term rates will move contrary to political objectives.

Encouragingly, markets still appear confident that the Federal Reserve's autonomy will endure, supported by reasonable candidates for leadership and broad recognition of its importance. Preserving this independence remains in everyone's best interest.

REFERENCES

Barro, R. J., and F. Bianchi. 2025. Fiscal influences on inflation in OECD countries, 2020–2023. *Economic Journal*. https://doi.org/10.1093/ej/ueaf066.

Bianchi, F., and Cosmin Ilut. 2017. Monetary/Fiscal policy mix and agents' beliefs. *Review of Economic Dynamics* 26: 113–39.

Bianchi, F., R. Faccini, and L. Melosi. 2023. A fiscal theory of persistent inflation. *Quarterly Journal of Economics* 138, no. 4: 2127–79.

Bianchi, F., R. Gómez-Cram, T. Kind, and H. Kung. 2023. Threats to central bank independence: High-frequency identification with Twitter. *Journal of Monetary Economics* 135: 37–54.

JOHN H. COCHRANE

John H. Cochrane is the Rose-Marie and Jack Anderson Senior Fellow of the Hoover Institution at Stanford University.

This essay summarizes a more detailed essay available on the author's *Grumpy Economist* Substack blog and webpage.

Federal Reserve independence is not an absolute virtue. We cannot have a completely independent agency that prints money to use as it sees fit.

Fed independence is limited and constrained by accountability—the cycle of appointments and reporting to Congress—a limited mandate, and limited tools. The mandate, including "price stability" and "employment," implies "and nothing else." No matter how important climate change or reshoring manufacturing may seem, the Fed must ignore them. Though printing money and handing it out can powerfully stimulate the economy, and confiscating money can stop inflation cold, taxing, spending, and economic regulation must be the province of politically accountable parts of the government.

Let us admit that there is, plausibly, a problem. The Fed has greatly expanded its activities, stepping into fiscal and political territory. Quantitative easing, by shortening the maturity structure, is fiscal policy. Mortgage-backed security purchases are credit allocation. Bailouts and market support transfer money from taxpayers to overleveraged financial institutions. The Fed expanded unwittingly, in the press of events, but it never retrenched.

Financial regulation is stuck in too big to fail, and too politically powerful to be required to issue more equity. The Fed waded into political issues like climate. And the Fed has presided over a banking collapse, two big bailouts, the Silicon Valley Bank (SVB) fiasco, and 10 percent inflation. The Fed has only offered "it's not our fault" excuses, not reforms. Excuses imply that the Fed is powerless to prevent a recurrence.

So, there is an important question: How should the terms of limited independence be reformed? We face a choice: The Fed could remain expansive, powerful, and political, but face more direct direction by elected officials, as is the Treasury. Or the Fed could return to a narrower scope of activities consistent with its current or even greater independence. I favor the latter course. But raising the drawbridge, hoisting the independence flag, and defending the status quo is not going to be tenable for long.

Why does independence matter? The rationale is weaker than we often suppose. Limits on Fed actions matter more.

"Insulate the Fed from political pressure," most say. Do not let the president goose the economy ahead of elections. But governments are tempted to hand out stimulus checks, tax exemptions, regulatory favors, loan forgiveness, and other goodies ahead of elections. Yet we do not entrust these policies to independent agencies. Moreover, "political pressure" is the same as "democratic accountability" when your party is in power. If independent central bankers run

amok, our elected representatives must have the power, eventually, to correct them. Independence must be limited, as it is.

Economists answer, "time consistency" and "precommitment." Precommitting to lower inflation in the future gives a better inflation-unemployment tradeoff now.

The interaction of fiscal with monetary policies is an even clearer precommitment problem. Precommitting to repay bondholders, rather than inflate away debts, makes the government more able to borrow. Historically, independent central banks have been instituted far more to precommit against debt monetization and financial repression than to forswear Phillips curve stimulus.

But other policies, such as capital taxes and sunk investments, have even clearer time-consistency and precommitment problems. Once investments are made, governments are tempted to tax capital, default on debt, or grab property, "just this once." Knowing that, people will not build or invest. Yet we do not assign taxing and spending to an independent Treasury.

Independence alone is a weak precommitment mechanism. Independent central bankers with the government's preferences will want to inflate every bit as much as the government does. Independence alone only works if the government appoints central bankers who are much more hawkish than the government. Such choices are not evident in appointments or Senate confirmations, to put it mildly.

Limitations on the Fed's *ability* to inflate are in economic analysis more effective precommitments. Finn Kydland and Edward Prescott's (1977) famous article was titled "Rules Rather Than Discretion," not "Appoint an Independent Fed and Let it Loose."

Independence is an important part of the package because monetary policy cannot be reduced to rules. The government can say where to go, but not how to get there. But the *constraints* on Fed action remain the meat of precommitment.

Resisting fiscal inflation is going to be the issue going forward, more than Phillips curve temptations. At 100 percent debt to GDP, each point of real interest rate is 1 percent of GDP additional deficit. President Donald Trump is already calling for lower interest costs on the debt, as after World War II. Will independence save us? No. In 2020, the Fed quickly monetized $5 trillion of new debt and kept interest rates low for a full year. The Fed cooperated voluntarily and enthusiastically with the administration. The Fed did not intend inflation, but it chose policies that over and over have had that effect.

Resisting fiscal inflation is much harder than resisting Phillips curve temptations. The decision to inflate versus enact spending cuts or tax hikes, or let a crisis burn, is intensely political. It is going to require a much stronger anti-inflation mandate from Congress, clearly signaling the elected branches' desire. That mandate has to include Congress' commitment to repay debts without inflation. Yet sometimes inflation is the least bad option. We would not want to lose World War II on the altar of price stability. Congress must stand ready to declare and take responsibility for the rare exceptions.

When the doctrine of independence developed, monetary policy had few fiscal implications, so it could be technocratic and a bit apolitical. That is not our world anymore.

Crisis intervention poses a similar precommitment problem. Bailouts are the only way to stop a run. Yet if the government predictably bails out creditors, then people have little incentive to avoid risk, and the government is forced to intervene more often.

Again, independence alone will not work. The Fed will not voluntarily abstain from intervening in a crisis just to contain moral hazard next time around. People will only believe the Fed (and Treasury) *will not* intervene if they *cannot* intervene, and *do not need* to intervene. And once a large enough crisis has started, not intervening is unwise. 1933 was pretty bad.

Again, rules and mandates have to be the centerpiece. Clean up (at last) the overleveraged financial system so the Fed does not need to intervene so often. Add serious limits so that the Fed cannot intervene, without explicit congressional declaration that the rules are suspended. Independence still helps: The administration is likely to want to bail out too often.

We should focus our analytical and historical efforts on mandates and limits: Gold, with good and bad parts; the mandate to hold down interest costs after World War II and coming soon. What does "price stability" mean? Was it wise for inflation targeters to drop employment and add numerical accountability? A financial stability mandate is growing. What does it mean? How is it limited? What limits on the Fed's tools should there be? Independence is only icing on the cake.

Bottom line: I think the Fed should remain about as independent as it is. But independence must be accompanied by a more explicit limited mandate, limited tools, and stronger accountability. Only this package will address the Fed's expansion into fiscal and political territory, while maintaining and enhancing the precommitments needed for successful monetary policy and financial regulation.

"Congress is dysfunctional," you may say. But especially in this room, we should not rush heedlessly to autocracy or aristocracy in place of checks and balances.

RANDALL S. KROSZNER

The previous speakers already discussed the definition of independence so I will just touch on it briefly here. I do think it's important, however, to make sure that we don't fall into the trap of considering independence as an end in and of itself.

To use an old-fashioned phrase, it can occasionally seem like there is a lot of clutching of pearls here, like "How dare you question the independence of the Fed?" We must always keep in mind that the Federal Reserve is part of the federal government. As such, it must be an accountable institution.

Some responses to the current situation seem to suggest that the Fed should be beyond criticism or that it's inappropriate to have it criticized so explicitly. I don't think that's correct. I think it needs to be subject to criticism and accountability.

Now, of course, you want the criticisms to be fair and appropriate as much as possible. Some people have argued that, well, this is something different, what we're experiencing now. Well, maybe in terms of being on social media or in the public. But I believe I'm the only one of the speakers who was a governor during the global financial crisis.

If you think that people weren't saying pretty tough things to us, often publicly and more often very directly behind closed doors, I'm not so sure that that's really accurate. People could be quite tough and really quite angry.

Not unsurprisingly, during a crisis, you have to find someone to blame. The Fed was sort of set up to be the whipping post when things go wrong. It's useful to have an institution to execute monetary policy and financial regulation as well as to have one to blame someone if something goes wrong. If you want to be loved, don't be a central banker! That's not the role, and that's perfectly reasonable.

We have to be careful about clearly defining central bank independence. We certainly don't want to define independence by outcomes. There have been, for example, a lot of very good outcomes from central banks that are not fully independent. Many of the central banks in emerging Asia, like in Taiwan, for example, are not formally independent, but produce good outcomes that reflect a broad political consensus.

The important role of political consensus is a theme I would develop here. You can have all the structural protections in place that you want, but there has to be a political consensus to sustain good outcomes. If you don't have that consensus, it doesn't matter because there's no such thing as precommitment in government. The government can change the rules.

Randall S. Kroszner is the Norman R. Bobins Professor of Economics at the Booth School of Business of the University of Chicago and an external member of the Bank of England's Financial Policy Committee and Financial Markets Infrastructure Committee.

These remarks represent the views of the author and do not indicate concurrence by other members of those committees or of the Bank of England.

The Federal Reserve Act could be changed at any moment. We were very mindful of that during the global financial crisis. We wanted to make sure that we didn't go beyond our mandate. We were doing a lot of new things at that time, and we tried to act boldly but within our mandate. We did not want Congress to say, "You've gone beyond your mandate, we have to clip your wings."

Of course, the postcrisis legislative changes did some of that, requiring signoff from the secretary of the Treasury or Congress to implement some programs that were done by the Fed on its own during the time that I was there. Congress also has debated whether to impose on the Fed a different inflation goal and a particular rule that it must follow to achieve that goal.

The sustained credibility of the Fed is crucial, ultimately coming down to the people who are there and the approaches that they take, as well as the broader political consensus about the role of the institution, rather than a narrow concept of independence as an end in and of itself.

A LOSS OF CREDIBILITY? ASSESSING MARKET IMPACTS

To assess credibility, I think it useful to consider the question: What is the impact on the markets? What we really care about is the impact on interest rates, inflation, expectations, investment, growth, employment, financial stability, etc. Certainly, these may involve some tough choices by the central bank.

What I want to do now is to look for evidence of potential changes in credibility as reflected in market pricing. I will do something very simple—what might be called "ocular" econometrics to present charts of a few series over the last year since President Donald Trump was elected. Clearly, there are many factors driving changes in asset prices and I am not controlling for those. Nonetheless, I think it is worth a look at the simple data.

More specifically, each chart begins on November 1, 2024 and ends with data from the last week of October 2025. (The charts are in my presentation posted on the PIIE conference webpage.) During this period, the criticism of the Fed intensifies in April 2025, after the so-called Liberation Day on April 2. But I also want to present that data starting in November 2024, because Trump certainly raised some critical issues about the Fed earlier.

First, consider longer horizon inflation expectations, namely, five-year, 10-year, and five-year, five-year forward, calculated using Treasury Inflation Protected Securities (TIPS) data. While we see moves around Liberation Day and the tariff issues, these measures of longer run inflation expectations have been flat to down.

Thus, it's hard to see an impact on longer term expectations of inflation.

Second, consider the yield curve. While the difference between the 10-year Treasury yield and the two-year Treasury yield is up marginally, the difference between the 10-year and the three-month yields continues to be roughly flat at zero. The yield curve also does not suggest a decline in inflation-fighting credibility.

Third, consider the so-called term premium on the 10-year Treasury. I'm always a little wary of talking about the term premium, because basically the term premium is what's left over after you use the things you understand to explain

interest rates. For those fans of the term premium, we still observe little change, roughly flat to down.

Fourth, consider long-term nominal interest rates. Here, you've certainly seen the 10-year rate move down. The interest rate on 30-year bonds, notably less liquid than the 10-year bond market, moved up and stayed up a bit after Liberation Day but has moved down to roughly where it was a year ago.

Fifth, consider the foreign exchange value of the dollar, measured by the trade-weighted *Wall Street Journal* dollar index. While the dollar did fall considerably from its recent high in January, as well as from the level when Trump was elected in November 2024, the dollar index has been basically unchanged since late April. The foreign exchange market is a deep liquid market where you might expect concerns about future high inflation or interest rates being held too low for too long to be manifest. That is not what the chart shows.

Sixth, consider the price of gold. The price of gold rises from the start of 2025 then jumps up a bit in April following Liberation Day. It's then flat until late August when it begins to rise extremely rapidly until it turns down rather sharply very recently. While this chart might allow you to say, "A-ha" that is where the loss of credibility is manifest, I would caution that the gold market is a relatively illiquid one so would be wary of drawing strong conclusions from it without other corroborating evidence.

THREE INTERPRETATIONS OF THE MARKET IMPACTS: "BUSINESS AS USUAL"?

What might then be alternative explanations for the movements in these series over the last year? **First**, markets are simply not paying attention to the Fed credibility issue. Given the amount of attention the issue has received, however, I don't find this plausible.

Second, the markets simply have it wrong. They are either misunderstanding or misestimating the impact of the loss of Fed credibility. A more charitable (and realistic) interpretation is that given that so many factors are changing, it is very difficult to estimate the impact. Thus, one must be cautious in drawing strong conclusions from the type of data I have presented here. While I certainly cannot reject these hypotheses—markets certainly did not anticipate the global financial crisis when I was at the Fed—it seems unlikely to me that we wouldn't see a bit more evidence of a loss of credibility in one of the more liquid markets where the impact should be relatively straightforward, such as in the value of the dollar.

Third, markets are treating the recent period as roughly "business as usual." In this alternative, markets believe Fed is always under political pressure and now it is just more explicit but not fundamentally different than in the past. This alternative strikes me as most consistent with the data.

This "business as usual" hypothesis, however, implicitly relies on an assumption about a broader political consensus to sustain credibility of the central bank over time. What I have in mind here is the role of other institutions, in particular, the role of the legal system and the Supreme Court. I'm delighted that one of the panels of the conference is devoted to the role of the Supreme Court and the ability to remove different types of presidential appointees.

In its May 22, 2025 decision in *Trump v Wilcox* concerning the interpretation and application of the so-called *Humphrey's Executor* to allow the president to remove of appointees to the National Labor Relations Board (NLRB), the Supreme Court went out its way to say that it may apply a different standard for the Fed:

> The Federal Reserve is a uniquely structured, quasi-private entity that follows in the distinct historical tradition of the First and Second Banks of the United States…[so decisions for other agencies such as NLRB do not] necessarily implicate the constitutionality of for-cause removal protections for members of the Federal Reserve's Board of Governors or other members of the Federal Open Market Committee.

The court discussed the Fed in its decision about the NLRB because an argument was made by Wilcox that, effectively, if you allow me to be removed then you have to apply the same standard to the Federal Reserve. As you can see in the quotation, the Supreme Court was extremely clear that it disagrees.

(A quick aside: While I would agree that the Fed does have a unique quasi-private structure, I'm not so sure about the historical connections to the First and Second Banks of the United States. Those banks were famously closed down because they—and in particular the Second Bank—were criticized as funneling money from the vast majority of the country to the elites in Philadelphia, New York and Boston. The regional and quasi-private structure of the Fed was adopted to address this criticism of the earlier banks.)

I believe that this Supreme Court decision in May is one of the reasons why we don't see any of these series I have plotted start to move up after the public criticism of the Fed intensifies in the spring of this year. I would argue that careful observers in the markets took comfort from this explicit differentiation of the Fed, supporting a "business as usual" view of Fed credibility, even if the public criticism may not have been business as usual.

Returning to one of the themes I mentioned earlier, I want to underscore the role of the broader political consensus and the effectiveness of government institutions generally for sustaining central bank credibility. Using data from 150 countries for 2000–23, Kenneth Kuttner finds that the World Bank measure of overall Government Effectiveness is much more important to explain inflation outcomes than measures of central bank independence.[1] The chart from his paper clearly shows that countries with greater overall government effectiveness have better inflation outcomes, even after controlling for the impact of central bank independence.

(A second, longer aside: A later panel will debate whether the Fed should have a role in banking supervision and regulation. I want to mention it here quickly because some have argued it is important to remove those roles to better preserve the Fed's independence and credibility. I would argue that it is important for the Fed to maintain these roles for crisis management reasons.

The Fed certainly does not have to be the sole regulator and supervisor but, without those functions, it will be difficult for the Fed to anticipate financial fragilities and to respond rapidly to a shock. Without the information, analysis,

1 Kenneth Kuttner, The Erosion of Central Bank Independence, *Econofact*, September 21, 2025.

and expertise that come with regulation and supervision, it will be difficult to make the quick decisions to deploy resources most effectively to avoid a collapse of the financial system and to support the economy.

I worry that without this knowledge and understanding internally, the Fed could be subject to substantial political pressure as others look to the Fed for action and support in high stress situations.)

CONCLUSIONS ON SUSTAINING CREDIBILITY

To conclude, I think it is important to remember that central bank independence is not an end in itself and that the crucial issue is credibility. Political consensus and effective government institutions, including the Supreme Court, play an important role in sustaining that credibility. I believe that markets interpret the Fed as almost always under political pressure since the Fed is part of the federal government and, hence, at least so far, treat the recent increase in intensity of public criticism as not substantially changing their expectations of outcomes.

II. Accountability for an Independent Federal Reserve

RICHARD H. CLARIDA
THOMAS DRECHSEL

RICHARD H. CLARIDA

Richard H. Clarida is the Lowell Harriss Professor of Economics and International Affairs at Columbia University and global economic advisor with PIMCO. He served as vice chair of the Federal Reserve Board of Governors from September 2018 to January 2022.

I begin by looking backward at the post-Bretton Woods historical record and received wisdom on the importance and benefits of central bank independence before looking ahead at some significant challenges to it that have emerged, I believe, as a consequence of the monetary policy responses to the global financial crisis, global pandemic crisis, and the postpandemic surge in global inflation.

Since at least Alesina and Summers (1993), recognition of the importance of central bank independence for sustaining price stability and delivering good macroeconomic outcomes is now widely understood and broadly—if not unanimously accepted—by elected officials in most countries (and respected by and within government institutions not only in advanced economies but in many emerging-market economies as well).

That said, our understanding of what exactly it means for a central bank to be independent has evolved, and I believe should continue to evolve. Guy Debelle and Stanley Fischer's (1994) classic dichotomy between "goal independence" and "instrument independence" of course remains relevant, but as the number and complexity of instruments in central bank toolkits increase, as their footprints in the financial system multiply, and as their overlap with fiscal policy and debt management expand, the distinctions can become blurred and the tradeoffs more complex.

As an aside, much of the academic literature on policy rules for setting monetary policy instruments independently—including papers I wrote earlier in my career—is at best incomplete as it assumes—usually implicitly—a clean separation between instruments of "conventional" monetary policy and other important considerations such as supervision and regulation, financial stability, fiscal sustainability, and the composition and maturity structure of central bank balance sheet. While this simplification may have been justified 25 years ago as a useful starting point, it is much less defensible today.

To cite just one example, I often found myself at the Federal Reserve asking how a potential policy decision on interest rates or the balance sheet would interact with the liquidity and capital standards required for banks. The literature on policy rules essentially treats supervision and regulation as a black box or assumes it away entirely, so really gives no guidance on how to incorporate these considerations into a traditional monetary policy decision. A real-world example of incomplete understanding of the interplay between traditional monetary policy and supervision and regulation was the disruption in the repo market in September 2019 that took the Fed, and the markets, by surprise.

Central bank independence today faces fresh and potentially serious challenges, triggered both by the political backlash against and—from different quarters—the enthusiastic support for some of the "unconventional" policies deployed and also the emergency Section 13 (3) lending facilities rolled out during the global financial crisis and global pandemic crisis. Although this was always understood, much of the original literature on central bank independence abstracted from the institutional architecture within which an individual central bank resides. Institutional details matter enormously not only for which goals are assigned but also for which instruments can be deployed and, in some cases, how they are deployed. Internationally, there are different modalities within which institutions grant or constrain central bank independence—legislative vs executive branch vs treaty. In the United States, the Federal Reserve is a creation of Congress, like the Department of Labor (DOL), which was also created in 1913, but unlike the DOL operates, at least for the time being, as an "independent agency" within the meaning and with the protections afforded by a 1935 Supreme Court case. Now while there is something like an agreed upon best practice template setting interest rates to hit an inflation goal, because the institutional foundations for central bank independence differ from country to country and are especially relevant for how goals are defined and in some cases which and how instruments are deployed, it is unlikely that we will see convergence to a single "best practice" model of central bank independence and increasingly less likely that actual and best practice in any given country will eventually coincide.

Up to now, I have been discussing central bank independence in the context of the traditional goals and instruments framework. But of course, one reason central bank independence is under challenge is the backlash against the extraordinary actions the Fed and other central banks undertook in 2008 and 2020 as well as of course also the postpandemic persistent surge in global inflation that caught most central banks off guard and thus initially put them far behind the inflation curve.

I begin with the observation that the tools of monetary policy are in general not exempt from the laws of economics—returns typically diminish and benefits usually incur costs. Regarding guidance, forward guidance, especially threshold-based or calendar-based guidance, has both benefits and costs, including costs to central bank credibility when such guidance shackles a central bank policy to an outcome it cannot directly measure. For example, in September 2020, the Federal Open Market Committee's muscular forward guidance tied liftoff in part to a threshold of estimated maximum employment. Maximum employment is notoriously difficult to measure in real time and even years after fact, and this was especially the case during the pandemic when labor market dynamics were in flux. There would seem to be important benefits to forward guidance that limits itself to variables the central bank can directly influence, such as inflation, rather than less observable metrics such as maximum employment. This approach to forward guidance would appear to be much more robust to the inevitable uncertainties about how to measure maximum employment or potential output.

Turning now to the balance sheet, four quantitative easing (QE) programs have been deployed by the Federal Reserve since the global financial crisis. However, the two "open-ended" QE programs, the Fed's QE3 and QE4 programs,

have proven in practice to be challenging to bring to a conclusion, for example, as was evidenced not only in 2021–2022 but also in the "taper tantrum" episode in 2013. The Fed's communication in December 2020 that it would continue QE4 until "substantial further progress" toward its dual mandate goals—including maximum employment—delayed liftoff and, in the event, constrained policy flexibility. Based on the US experience with QE3 and QE4 and the cross-country analysis of the post pandemic unwinding of QE programs in other advanced economies it would seem there can be substantial benefits to clarifying ex ante both the rationale for and the duration of a future contemplated quantitative easing program. As for the composition of the Fed balance sheet, I think there is a compelling case, as Governor Christopher Waller, has suggested for the Fed to shorten significantly the average maturity of its Treasury portfolio. Indeed, I would go further and argue in favor of a System Open Market Account portfolio with substantially shorter weighted average maturity than that of Treasuries in the hands of the public as was the practice in the years before the global financial crisis.

REFERENCES

Alesina, Alberto, and Lawrence Summers. 1993. Central bank independence and macroeconomic performance: some comparative evidence. *Journal of Money, Credit and Banking* 25, no. 2 (May): 151–62.

Debelle, Guy, and Stanley Fischer. 1994. How Independent Should a Central Bank Be? In *Goals, Guidelines, and Constraints Facing Monetary Policymakers*, ed. Jeffrey C Fuhrer. Federal Reserve Bank of Boston Conference Series no. 38: 195–221.

THOMAS DRECHSEL

Thomas Drechsel is an assistant professor at the Economics Department of the University of Maryland.

According to conventional wisdom, independent monetary policy is an institutional arrangement that has served society well. This consensus view is widely shared by academics and policymakers, has shaped the conduct of monetary policy around the world, and has arguably underpinned central bank credibility. Yet, the current political debate around the Federal Reserve invites a nuanced reflection.

In this essay, I would like to offer my thoughts about how to add perspective, subtlety, and perhaps limitations to conventional wisdom. By drawing on my experience with conducting research on the economic consequences of political pressure on the Fed, I ask what empirical research can teach us about central bank independence, beyond conventional wisdom. I also reflect on what it cannot yet teach us, by highlighting important open questions.

WHAT RESEARCH HAS ALREADY TAUGHT US

Empirical research has already been successful at deepening our understanding of benefits and threats to monetary policy independence. The insights largely support conventional wisdom. They also enrich it, in at least two dimensions.

First, empirical research has provided us with *quantitative magnitudes*. Studies have estimated, for example, how much worse inflation outcomes become when monetary policy independence erodes, or to what degree credibility losses translate into higher inflation expectations.

Second, empirical research has illuminated *economic mechanisms*. Studies have sharpened our understanding of why an erosion of monetary policy independence leads to higher inflation and have highlighted the specific economic forces that are at play.

While this is an active research area and I cannot provide a thorough review in this essay, two recent studies are worth highlighting briefly. Bianchi et al. (2023) use high-frequency identification with social media data to show how threats to central bank independence shape market expectations of interest rates and inflation. In my own work (Drechsel 2025), I study episodes of political pressure on the Fed, combining historical narratives and new data to estimate how such pressure affects macroeconomic outcomes.

WHAT IMPORTANT QUESTIONS RESEARCH HAS RAISED

Besides supporting and enriching the consensus view, research on central bank independence has also raised important questions that, to me, remain open. These questions are conceptual as much as empirical, they deserve continued attention, and they might help to keep discussions productive in the current political climate. I want to highlight four open questions.

Question 1: What are good comparisons?

Empirical researchers think hard about which kind of variation in the data they can exploit to gauge cause and effect. Early studies, like the seminal work of Alesina and Summers (1993), exploited cross-country variation. Essentially, the analysis boils down to a comparison between Switzerland and Turkey with respect to their monetary policy independence and inflation experience. More recent work has turned to time-series variation within a single country, especially the United States. The essence here is a comparison of the United States under Nixon with the United States under Bill Clinton with respect to the degree of political pressure on the Fed and the resulting inflation experience.

Both strategies and their underlying comparisons are justifiable and yield important insights. However, each raises its own challenges. Importantly, the question of good comparisons is not only relevant to researchers. It is a question we should ask also in policy debates. Good comparisons are often insightful. But when a commentator argues "this feels like Turkey" or "we are back to the 1970s," it is worth thinking carefully about when these comparisons are useful and justified and when they are not.

Question 2: Is the United States special?

The second question follows naturally from the first. The United States is clearly not just a data point like any other. It is the center of the global financial system and the issuer of the world's reserve currency. Does this central role make the United States more vulnerable to the erosion of monetary policy independence, or instead more resilient?

One could argue that the special role of the United States makes the risks greater. With global financial flows gravitating around the United States, a loss of confidence in the Fed's independence could reverberate across the world.

But the opposite argument also has merit. As the dollar is indispensable, perhaps the market's discipline on the United States is weaker. When a smaller economy undermines its central bank, capital flees quickly and borrowing costs rise. When the United States does it, investors might be more complacent due to lack of alternatives.

Question 3: How is central bank independence different from monetary policy independence?

The title of this conference contains the term "central bank independence," but my description of the prevailing conventional wisdom deliberately relates to "monetary policy independence." While the two terms are sometimes used interchangeably, the distinction is important.

Modern central banks do much more than setting interest rates. They supervise banks, manage payment systems, implement macroprudential policies, and, since the global financial crisis, have employed a wide array of nonstandard policy tools. US Treasury Secretary Scott Bessent recently criticized the growing footprint of central banks by suggesting that "Overuse of nonstandard policies, mission creep, and institutional bloat are threatening the central bank's monetary independence."

Whether or not one agrees with Secretary Bessent's assessment, the case for independence based on empirical evidence does get more uncertain as we consider central bank actions outside the core function of monetary policy. My reading of the academic literature is that non-standard monetary policies were on net successful. I am also aware of empirical research that asks, for example, whether central banks should also be bank regulators. However, my sense is that academic research still has room to grow in confronting these questions. If we care about preserving monetary policy independence, we need to reflect on what range of tasks we assign to central banks and back up our arguments with hard evidence.

Question 4: How are central bank transparency and accountability related?

My final question relates to a pair of central bank attributes often appearing alongside each other: accountability and transparency. Are transparency and accountability complements or substitutes? Does one lead naturally to the other?

Put simply, transparency means being open and visible, while accountability means being answerable. Over the past few decades, central banks have become dramatically more transparent: regular press conferences, published minutes, and frequent speeches by decision-makers. For empirical researchers, all of these materials have been an intriguing data source.

However, it is not so clear that more transparency has also made central banks more accountable. Criticism of central banks does not appear to have declined following their growing transparency, though making causal statements on these patterns is tricky. In any case, finding the right balance between independence, transparency, and accountability is a governance challenge for modern central banking. Not all questions surrounding this challenge have been answered, neither in research nor in practice.

CONCLUSION

Independent monetary policy has served society well. Rigorous evidence supports it, and practical experience confirms it. Yet we should continue to study questions surrounding appropriate comparisons, US exceptionalism, the scope of central bank mandates, and the relationship between transparency and accountability. Both researchers and policymakers will hopefully continue to think about these questions with an open mind and engage with each other.

REFERENCES

Alesina, Alberto, and Lawrence Summers. 1993. Central bank independence and macroeconomic performance: some comparative evidence. *Journal of Money, Credit and Banking* 25, no. 2 (May): 151–62.

Bianchi, F., R. Gomez-Cram, T. Kind, and H. Kung. 2023. Threats to Central Bank Independence: High-Frequency Identification with Twitter. *Journal of Monetary Economics* 135: 37–54.

Drechsel, T. 2025. *Estimating the Effects of Political Pressure on the Fed: A Narrative Approach with New Data*. NBER Working Paper 32461. Cambridge, MA: National Bureau of Economic Research.

III. US Legal and Constitutional Perspectives on Independence

CAROLA BINDER
PAUL TUCKER
STEPHEN I. VLADECK

CAROLA BINDER

Carola Binder is an associate professor of economics at the University of Texas at Austin's School of Civic Leadership and the author of *Shock Values: Prices and Inflation in American Democracy*.

Economic theory, historical experience, and empirical evidence all point to the importance of central bank independence for price stability and other favorable macroeconomic outcomes. Recent threats to central bank independence in the United States are therefore an obvious cause of concern. But it is worth taking a step back to ask where these threats are coming from, and why they seem to be escalating.

What I would like to emphasize is that independence requires legitimacy. The deepest threats to Federal Reserve independence come when legitimacy is lacking; the surest way to safeguard independence is to bolster legitimacy. It is not enough to make an empirical case for the benefits of independence; it is not enough for the Fed to use its independence to achieve outcomes that most of us would consider good. The ends do not justify the means. The means must be legitimate.

Let me explain what I mean by legitimacy. In 1962, Milton Friedman wrote that "The device of an independent central bank embodies the very appealing idea that it is essential to prevent monetary policy from being a day-to-day plaything at the mercy of every whim of the current political authorities." But Friedman asked, "Is it really tolerable in a democracy to have so much power concentrated in a body free of democratic control?" (1962, 180). Legitimacy is what makes it tolerable.

Legitimacy is usually defined as the belief that an authority or institution is rightful, appropriate, and just. For an independent agency in the United States to be considered legitimate, it also must be created and structured in a manner that upholds constitutional principles and core political values, including accountability, the separation of powers, and the rule of law. This is extraordinarily important when the independent agency is extraordinarily powerful, as is the case for the Federal Reserve.

The Fed faces constitutional or structural challenges to its legitimacy stemming from modern Supreme Court jurisprudence that has become increasingly skeptical of independent agencies and the administrative state. As Daniel Tarullo has noted, "The low intensity offensive against the administrative state that has been waged by the conservative Justices of the Supreme Court for well over a decade has escalated in the last several terms" (2024, 2). This trend in jurisprudence raises doubts in several key areas: the removals process, the appointments process, and the delegation of legislative power. Questions of removal and appointments are related, since both stem from Article II, Section 2 of the Constitution.

The removal issue is most pressing for the Fed following recent cases that have revived a more rigid view of the separation of powers in this context. For example, *Seila Law LLC v. Consumer Financial Protection Bureau* (2020) and *Collins v. Yellen* (2021) have cast doubt on "for cause" removal restrictions for heads of agencies that exercise significant executive power. In 2025, the Supreme Court upheld President Donald Trump's removal of Democratic members of the National Labor Relations Board and Merit Systems Protection Board despite their statutory removal protections. The Court also allowed Trump to temporarily fire Federal Trade Commission (FTC) commissioner Rebecca Slaughter while the justices consider her legal challenge. During upcoming oral arguments for *Trump v. Slaughter* (2025), the Court will likely address whether to overturn *Humphrey's Executor v. United States* (1935), a landmark case also involving the firing of an FTC commissioner, which has set the precedent preventing presidents from removing independent regulators without cause. An overturning of *Humphrey's Executor* would greatly expand the president's control over independent agencies, including possibly the Fed, and at a minimum would leave the for-clause removal protection of Fed governors on a weaker footing.

Regarding appointments, Article II of the Constitution requires "Officers of the United States" to be appointed by the president with the Senate's consent, though Congress can vest the appointment of "inferior officers" in heads of departments. Here, too, there are some grounds for doubts about the Fed's structure and governance. In particular, the five voting regional Fed presidents on the FOMC seem to be officers of the United States following the precedent of *Buckley v. Valeo* (1976) because they exercise "significant governmental duty." If it is decided that they are primary officers, rather than inferior ones, then their appointment by private boards would violate the appointments clause. In *United States v. Arthrex, Inc.* (2021), the Supreme Court ruled that the Administrative Patent Judges at the US Patent and Trademark Office were not inferior officers because of the "unreviewable authority" that they wielded. By that standard, it is not outside the realm of possibility that Reserve Bank presidents on the Federal Open Market Committee (FOMC) are also primary officers.

The third trend in jurisprudence that is potentially challenging for the Fed is renewed interest at the Supreme Court in the nondelegation doctrine. Justice Neil Gorsuch and other proponents of a revived nondelegation doctrine assert that Congress's practice of delegating wide authority to agencies undermines democratic accountability and the separation of powers. Gorsuch's dissent in *Gundy v. United States* (2019) signaled a willingness to replace the current "intelligible principle" standard—a deferential test used for decades—with a more stringent approach. The Fed's mandate to promote "maximum employment, stable prices, and moderate long-term interest rates" is a broad delegation of authority that has not been seriously challenged, and seems unlikely to be in the near future, though it is likely to face more scrutiny.

In the face of these constitutional questions, the Supreme Court has indicated that the Fed might claim a "special historical status" or be an anomaly justifying an exception. In May 2025, the Court signaled a distinction between the Fed and some other administrative agencies, calling the Fed a "uniquely structured, quasi-private entity." Notably, Fed Governor Lisa Cook is able to remain in her position while awaiting oral arguments in her case in early 2026. This special status for the Fed is quite practical, and even many unitary executive theory

proponents are reluctant to question Fed independence. However, exceptions carved out just for the Fed risk appearing arbitrary. If the Fed's importance justifies its independence, then other critical agencies could make similar claims. If its historical pedigree is the reason, that history is complicated and not a clean fit for the modern institution. A Fed exception based on pragmatism and lacking a coherent, generalizable principle may not hold up indefinitely especially if the popular and political consensus supporting Fed independence further erodes. And here there is some cause for concern.

In particular, a recent Pew poll finds that just under half of respondents have a favorable opinion of the Federal Reserve, with 23 percent of respondents unsure. There are also large partisan differences, with The Economist/YouGov Poll (August 29 to September 2, 2025) finding that 47 percent of Democrats but just 18 percent of Republicans approve of how Jerome Powell has been handling his job as Fed chair. Many consumers surveyed in 2017, 2019, and 2021 by the University of Michigan reported that they had less trust in the Fed compared to five years prior. That is regardless of their political party. But we also see that when they share a party with the president, their trust declines less. This partisan nature of trust in the Fed shows up even in the longer-run inflation expectations of consumers. My recent work with Rupal Kamdar and Jane Ryngaert (2024) shows that inflation expectations are highly partisan. When people are of the same party as the president, they have lower inflation expectations by a lot. That gap also has grown a lot in recent years.

Across consumers of all parties, the anchoring of inflation expectations, perhaps the clearest indication of Fed credibility, also shows signs of weakening. For example, a recent study by Boston Fed researchers Philippe Andrade and Michael Wicklein (2025) finds that rising salient prices and broad-based inflation do not fully account for the recent rise in inflation expectations. The large unexplained portion of the rise may signal weaker anchoring. We can also look at longer-run inflation expectations in the Michigan Survey of Consumers. The median has risen well above the Fed's target and well above its usual levels since the target was announced. The standard deviation in long-run expectations, a measure of disagreement across households, has also risen and is in fact higher than it was even in the late 1970s and early 1980s.

I take all of this survey evidence as warning signs that legitimacy is on shaky grounds, which leaves the Fed more susceptible to attacks on its independence. The situation is exacerbated by Trump's public criticism of the Fed and its officials, but we should not think of it as being specific to this administration. Large government deficits, and soaring interest costs on the national debt, imply that there will be growing pressure to make monetary policy subservient to the government's funding needs.

What are the possible solutions? One is to strengthen external checks and balances on the Fed, which would enhance its public accountability and legitimacy. The Fed itself could also act preemptively by providing greater transparency about the policy rule, how they plan to balance their price stability and employment objectives when they conflict, and how they plan to use unconventional monetary policy tools in the future.

To close, the recent trends in jurisprudence toward the administrative state did not come out of nowhere. Courts, like the general public, increasingly perceive agencies as politically influenced and partisan, rather than neutral,

scientific bodies. And even if the Supreme Court upholds the Fed's current structure in foreseeable future, lingering doubts about its constitutionality will exacerbate problems of partisanship and low trust.

REFERENCES

Andrade, Philippe, and Michael Wicklein. 2025. *Why Have Inflation Expectations Surged Recently? A Historical Perspective* (October). Federal Reserve Bank of Boston Research Paper Series Current Policy Perspectives Paper No. 25-14. https://ssrn.com/abstract=5585193.

Binder, Carola Conces, Rupal Kamdar, and Jane M. Ryngaert. 2024. Partisan expectations and COVID-era inflation. *Journal of Monetary Economics* 148(S). https://www.sciencedirect.com/science/article/pii/S0304393224001028.

Friedman, Milton. 1962. Should There Be an Independent Monetary Authority? In *In Search of a Monetary Constitution*, ed. Leland B. Yeager. Cambridge, MA: Harvard University Press.

Tarullo, Daniel. 2024. The Federal Reserve and the Constitution. *Southern California Law Review* 97, no.1. https://southerncalifornialawreview.com/2024/05/14/the-federal-reserve-and-the-constitution.

PAUL TUCKER

Paul Tucker is research fellow of the Mossavar-Rahmani Center for Business and Government at the Harvard Kennedy School. He was the deputy governor of the Bank of England (2009–2013) and is the author of *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State* (2018).

Central banks are shaped by law. It was for reasons of legitimacy that after the 2007–09 global financial crisis, the Bank of England urged the new coalition government and parliament not to give us certain powers and to add extra constraints around some of the new stability-related powers that were coming our way. We largely prevailed. I mention that because I have not seen that kind of "do not make us too powerful" culture at the Federal Reserve over the many years I have been able to observe it.

This conference is about the Fed, particularly in the light of the cases that will be heard by the US Supreme Court. But it should be said that in some ways these issues are about the legitimacy of the Supreme Court itself. In that context, I'd like to recommend the late Richard Fallon's book on the legitimacy of the Supreme Court, which came out at around the same time as my own *Unelected Power*.

To substance: I want to offer an argument, a rather simple argument, for why monetary independence is distinguishable from the independence of other delegated functions, such as securities regulation and so on. The argument rests on a fundamental pillar of republican and liberal governance (I use "liberal" in its old European sense).

Many granular arguments are being advanced for why the Fed should be distinguished. Whatever their merits, those arguments, and more important, whatever the justices decide, are going to have to rest on some big principles. I say "have to" because the decision needs to make sense to people, both experts and interested members of the public. I think there is such a principle: the separation of powers.

Typically, when people talk about the separation of powers, what they instinctively think about is the independence of the judiciary from the elected people in the legislature and executive government. But there is another elemental part of the separation of powers, which is not only in the US Constitution but is vital to the history of constitutionalism. In my country, the United Kingdom, going back to the mid-medieval period, there developed a norm that the king—or, more abstractly, the ruler—shall not be able to tax the people without consent.

This matters a lot because—the second step in the argument—the monetary levers are always latently an instrument of taxation. Most obviously by surprise inflation or deflation, but actually in more subtle ways, even without massive surprises. What follows from that is a negative proposition: The last officer of the state who should hold the monetary levers in a constitutional republic, or what I

would call a liberal democracy, is the head of the executive branch. The monetary levers belong ultimately with the elected assembly.

For much of our history—not just since the US was founded, but the modern era more generally—assemblies essentially solved this via the gold standard. In Britain, decisions to come off gold during the Napoleonic Wars, and to go back onto gold afterwards, were taken by the parliament. Formally, those were decisions not taken in Threadneedle Street, nor in Downing Street. The gold standard belonged, as it were, to parliament which, on the recommendation of the executive, passed an act authorizing the central bank to suspend conversion of notes into gold.

We discovered in the 1930s, however, that the gold standard was not sustainable under full-franchise democracy. The United States discovered the same for itself in the early 1970s when it came off gold, bringing an end to the Bretton Woods system. The violence, if you like, of the swings in real economic activity—in real demand, output, and jobs—entailed by sticking to the gold standard could not be maintained when those suffering had the vote. In the gold standard's 19th century heyday, the UK had a property-owning, property-franchise-based democracy, as did some US states until the middle of the 19th century.

If something like that is correct, then the question is what other choices does the legislature have for its monetary regime. There are not many. In theory, one choice would be to have a committee of the legislature meet to set interest rates, routinely and in emergencies. I hope you agree that is for the birds. So, if it cannot properly be handed to the elected executive, delegation to a central bank emerges as a solution to a problem of reconciling price stability with the separation of powers under full-franchise democracy.

That poses the question, a vital question, of what constraints should be placed on that institution so that the delegation does not create some kind of unelected monetary king. My answers, which include plenty of preconditions and constraints, were set out in *Unelected Power*, and I am not going to repeat them here. I mention them because the constitutionalist case for an independent monetary authority does not remotely entail untrammeled powers.

Summing up so far, I have argued that when the high-level question comes up as to whether the court (here or in any other constitutional democracy) should accept laws that give the monetary levers to the executive branch, the answer is no, they should not. The reason lies in a very basic principle that is not only enshrined in the Constitution but helps to motivate the Constitution itself.

That is the main thing I want to say. Let me add two other points, one concerning central banking and one concerning the administrative state.

On central banking, since the Fed's role in supervision and regulation has come up, I might briefly say something about its warrant. It is this. In a monetary economy, only the central bank can act as a lender of last resort (LOLR), since only it can create the most basic safe asset—its own money—at lightning speed; waiting for hours for a finance ministry to issue treasury bills will not cut it. Any LOLR will naturally—organically—have some supervisory role since it will want to ensure it is repaid, and so will want to know about the banks it is lending to and about the collateral it is lending against. It will also naturally want some kind of say in the regulatory requirements, because if they are too lax, it will be more active as LOLR. If the Fed's functions in this area were taken away,

the United States would find itself with more fiscal (equity) bailouts. Beware of what you wish for.

Finally, let me just say something briefly about the agencies known here as commissions. Partly for the reasons already given and partly perhaps for some other reasons, one can distinguish between, say, the current Federal Trade Commission (FTC) case and cases concerning the Fed.

First, everybody here knows that if after a general election there is a change of administration, then under what has become an established norm the chairs of the regulatory commissions—the Federal Communications Commission (FCC), Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation (FDIC), Federal Trade Commission (FTC), and so on—submit their resignations. This enables the president to fill the vacancy on the five-member panel. This has the effect of maintaining the 3–2 balance of party representation on the commissions—three for the president's party, two for the other party, giving the majority to the incoming administration. That does not happen at the Fed. There is no such norm that it should happen. That is tremendously important in terms of social norms. To equate the independence of the FCC with the independence of the Federal Reserve is to make a category mistake in terms of US practices.

The distinction alerts us to the importance of what counts as independence. If thought of as independence from quotidian politics, there are three things. One is that the president (or in other countries the prime minister) cannot get out of bed and say, "I'm sick of this person, you're sacked."

Second is that the treasury secretary cannot casually issue a directive that says, "This is what you should do." There should be no law that gives them a directive power in normal circumstances. If there is any such law, it should be restricted to carefully specified, emergency-type situations, with a clear carve-out in the primary legislation. Such a thing exists for the Bank of England.

And the third thing is that an independent agency, as defined, should not have to go and get its funding from the elected assembly every year. Because if it does, the assembly—the congress, the parliament—is undoing or undermining its intention to delegate something in a way that puts it at arm's length from day-to-day politics. Here, the commissions are subject to annual appropriations. They are not independent as I am defining it. Whether, normatively, the FTC, FCC, etc. should be independent is another matter. I do not think they should all be independent. I'm going to address the criteria for degrees of independence appropriate for other agencies in the book I am working on.

But, to reiterate, the monetary authority is different. If the Supreme Court decides that the president can control the monetary levers, your country will have given up one of the most basic principles of constitutionalism, the separation of powers. It would be ironic, and tragic, if that holds up in an old parliamentary democracy but not here.

STEPHEN I. VLADECK

Stephen I. Vladeck is the Agnes Williams Sesquicentennial Professor of Federal Courts at Georgetown University Law Center and the editor and author of "One First," a regular newsletter about the Supreme Court.

To be sure, something must have gone very, very wrong for me to be speaking at a conference like this. That said, I'll do my best in my opening remarks to set the stage for this afternoon's conversations through the lens of the ongoing clash in the Supreme Court between central bank independence and the unitary executive theory.

Our story largely begins with the Supreme Court's 1935 decision in *Humphrey's Executor* v. *United States*. In that case, the Supreme Court unanimously affirmed the constitutionality of statutory removal protections for commissioners on the Federal Trade Commission (and similar independent agencies), in a significant rebuff of President Franklin D. Roosevelt.

Humphrey's Executor came to be the foundation for dozens of comparable for-cause removal protections in statutes covering just about the whole gamut of executive branch agencies. And it *has* stayed that way—for nearly 90 years.

It really was only in the 1980s that we first saw the rise of what has been called the "unitary executive theory." I wish I could tell you that it was really sophisticated. But it reduces to the relatively basic argument that the first sentence of Article II of the Constitution, by providing that "the executive power" is vested in the president, means "and nobody else," and that's it.

This theory was first embraced in a visible sense by Justice Antonin Scalia in a solo dissenting opinion in 1988 in the *Morrison* v. *Olson* case. *Morrison* was not about an official like poor Mr. Humphrey; *Morrison* was about an inferior officer, specifically, the independent counsel within the Department of Justice, for whom there was a similar for-cause removal restriction.

And Justice Scalia suggested that that restriction violated what was, at least to that point, a never-previously embraced theory. But Scalia was a one-man band on this question all the way through the tenure of Chief Justice William H. Rehnquist. For as conservative as Rehnquist was, for as much of a defender of executive power as he was, he never embraced this theory. In fact, he wrote the majority opinion in *Morrison* from which Scalia was dissenting.

It was only after John Roberts became Chief Justice and Samuel Alito replaced Sandra Day O'Connor that we started to see a real push to get the court to embrace more of the unitary executive theory. That began in 2010 with the *Free Enterprise Fund* case, in which a 5–4 court held that Congress can't provide for two layers of for-cause removal. And this is a real sentence in a Supreme Court opinion: "two layers are not the same as one."

At its core, the central premise of *Free Enterprise Fund* was that this multi-level for-cause removal was novel. Indeed, the majority went out of its way to

stress that it was *not* undermining the statutory schemes upheld in *Humphrey's Executor* or *Morrison*.

Then, in 2018, Justice Kennedy retired. And within two years of his retirement, that changed. The court said lots of critical things about *Humphrey's Executor* in *Seila Law* v. *Consumer Financial Protection Bureau*. In that case, the court struck down for-cause removal protections for any agency where the head was one person as opposed to a multi-member commission.

But it went further. The parts of the opinion that were joined by all of the conservative justices and none of the Democratic appointees formally embraced the unitary executive theory, holding out *Humphrey's Executor* and *Morrison* not as distinct principles, but as two outlier exceptions to the rule. Thus, unless Congress was following one of those two models, any restriction on the removal of an executive officer by the president was *per se* unconstitutional.

That's where things stood on January 20: Novel structural arrangements would be problematic if they insulated agency officers from direct presidential control. But as long as the removal protection followed the *Humphrey's Executor* or *Morrison* model, it was fine. And of course, the *Humphrey's Executor* model also encompasses the Federal Reserve Board of Governors.

Then President Donald Trump came to office. Very early on, the Justice Department signaled its interest in pushing the Supreme Court to overrule *Humphrey's Executor*. And indeed, they set out to test this by firing without cause a whole slew of members of *Humphrey's Executor*-model commissions.

I'm sure it was a coincidence that all the people who were fired were Democrats. Regardless, the president fired without cause members of the Merit Systems Protection Board, the National Labor Relations Board (NLRB), the Consumer Product Safety Commission (CPSC), and the Federal Trade Commission (FTC).

In all of those cases, federal district courts said, wait a second, *Humphrey's Executor* is still the law. And so, obviously, we're not going to let you fire these people. The courts thus blocked each of the firings. And in all of those cases, the courts of appeals agreed, and denied the Trump administration's request to let Trump fire them while the cases went ahead. And in all of those cases, the Supreme Court issued its own stays—greenlighting the officials' removal.

These rulings were part of a broader phenomenon in which the Supreme Court over the last nine months has been incredibly aggressive in granting emergency relief to the Trump administration. Just to put this in context, as of October, the administration has sought emergency relief 30 times since January 20.

The Bush and Obama administrations between them in 16 years sought that kind of relief eight times. So, we've gone from once every other year to once every week and a half. That's a big difference. And one of the real themes of those applications has been vindication of the unitary executive theory—by allowing Trump to fire senior agency officials without cause.

The first of these rulings was *Trump* v. *Wilcox*. This was in May. Heading into *Wilcox*, folks like me were unsure what the Supreme Court would do because we all assumed that the Court would be wary of any ruling that might apply to the Fed, as well—since the Fed board's independence is protected by a statutory provision materially similar to the statutes at issue in those cases. The assumption

was that, if the Supreme Court undermined *Humphrey's Executor*, the collateral damage would include the Fed.

Not to worry, said the Supreme Court on May 22. In a ruling that cleared the way for Trump to remove members of the NLRB and MSPB, the court wrote, "The Federal Reserve is a uniquely structured quasi-private entity that follows in the distinct historical tradition of the first and second banks of the United States." I don't think I need to tell you how completely stupid that sentence is. But its analytical unpersuasiveness notwithstanding, the fairly obvious point of that sentence was the justices in effect saying "Don't worry, markets, we're not coming for the Fed."

Then, in July, a district court had tried to distinguish *Wilcox* by suggesting that it was only about the NLRB and the MSPB. Obviously, the court explained, the Consumer Product Safety Commission is totally different. And the Supreme Court said, nope, not different.

Then we had Rebecca Slaughter, who was a commissioner for the same exact agency as the agency in *Humphrey's Executor*—the FTC. The lower court said, well, this isn't *Wilcox* because it's the exact facts of *Humphrey's Executor*. And the Supreme Court said, no, not different.

Not only that, but in the *Slaughter* case, the court granted certiorari "before judgment," bypassing the court of appeals to decide if it should overrule *Humphrey's Executor*, even though it kind of already had.

The *Slaughter* case is going to be argued in December and raises the *Humphrey's Executor* question. It also raises a second question about what the remedy is for cases in which someone is unlawfully removed from office. And that's especially important because of the fourth of these cases—the case about Fed governor Lisa Cook.

In the Lisa Cook case, taking cues from *Wilcox*, Trump did not purport to fire Cook *without* cause. Rather, he claimed there *was* cause—via an increasingly dubious claim of mortgage fraud. The lower courts blocked the firing, and the Trump administration once again went for a stay.

This time, instead of granting or denying the stay, the court chose Door #3—which was to defer its ruling on the stay pending an oral argument in January. It's only the fifth time since 1971 that the Supreme Court is hearing an oral argument on an emergency application.

And it suggests that the court is at least in some respect waiting to see what happens in the *Slaughter* case before deciding what to do with Lisa Cook. It also suggests that the court is continuing to be very mindful that, in its rush, and I do mean *rush*, to embrace the unitary executive theory and to relegate *Humphrey's Executor* to the historical dustbin, it still wants to come up with some way to carve out the Fed—even if it is completely, utterly, and irredeemably analytically unpersuasive.

That's how we got here.

IV. Independence for Monetary Policy versus Financial Regulation and Supervision

JOYCE CHANG
ADAM S. POSEN
AMIT SERU
DANIEL K. TARULLO
CAROLYN A. WILKINS

JOYCE CHANG

Joyce Chang is chair of global research at J. P. Morgan.

I am honored to be with such a distinguished group of scholars on this important topic. In today's marketplace, everyone has had to become an amateur observer of the Supreme Court, given the number of decisions making their way to the courts. I have learned so much from today's proceedings. It appears I am the only market participant in the conference, and I wanted to thank Adam Posen for the invitation and also express how much I appreciate the work by John Cochrane and David Wilcox in assembling such a distinguished group of experts.

Before introducing questions from the panelists, I would like to offer a market perspective on financial supervision and regulation. Anna Gelpern and Lev Menand have set the stage well, highlighting that the issue of Federal Reserve independence is seen by market participants as distinct and separate from considerations around financial regulation and supervision.

From a market participant's viewpoint, there are three key themes that currently define the state of financial regulation.

First, as John Cochrane pointed out, there is an ongoing concern about being "stuck in too big to fail." The next crisis may not resemble past ones, especially given developments outside traditional depository institutions and the rise of digital assets. This raises questions about the objectives of bank supervision beyond simply preventing bank failures, particularly as financial markets evolve rapidly and more activity is occurring outside the banking system. At J. P. Morgan, we frequently discuss whether current approaches are simply pushing more activity outside the banking system.

Second, complexity is a major critique. The Federal Reserve Bank plays a central role in financial supervision, but from a banking perspective, there is significant overlap in rules—such as those governing global systemically important banks (G-SIBs), comprehensive capital analysis and review (CCAR), and Basel III—and among regulators, including the Office of the Comptroller of the Currency (OCC), Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Consumer Financial Protection Bureau (CFPB), and Federal Housing Administration (FHA), among others.

Over the past four years, in particular, many in the financial markets have questioned whether regulation is sometimes "in search of a problem," which has contributed to lawsuits against the Fed focused on duplication and complexity.

I urge you to review a Bloomberg News analysis that sorted through 218 disclosures of new, finalized financial regulations filed with the Office of Management and Budget. By their estimate, combined with rules already in place,

the new regulations brought the tally of annual paperwork to 425 million hours, or additional tasks that would require 26,500 full-time workers.

Third, accountability is a critical issue. The public should have the ability to dispute supervisory decisions, and we must ask whether the marginal benefits of regulation justify the costs. There may be larger issues that deserve prioritization. As Lev Menand mentioned, some of the most acute institutional concerns about Fed independence have subsided as the candidates for key appointments seem reasonable and the extreme rhetoric on the institutional framework has moderated. More time could be dedicated to examining how the Fed could improve its balance sheet management and communication. For example, the recent decision to end quantitative tightening (QT) was made without much public discussion or cost-benefit analysis of quantitative easing (QE) and QT.

This panel presents an excellent opportunity to discuss which aspects of the Fed's approach to financial regulation and supervision are effective, which require reform, and how we might reassess and improve bank supervision. We must also consider how to address the risk of politicization and its implications for banking, financial stability, and innovation. As more financial activity moves outside the formal banking system, what is the best way to regulate it?

In closing, I would like to briefly address the topic of stablecoins, building on comments from Amit Seru and Carolyn Wilkins. It is not clear that the Fed should supervise stablecoins and that whether access to the Fed balance sheet should be assured. I am also not convinced that stablecoins will grow as rapidly as some estimates suggest. J. P. Morgan's best estimate is that the market size for stablecoins has the potential to grow to between $600 billion and $1 trillion over the next several years.

More work is needed to explore tokenized deposits on public blockchains as a way to institutionalize the benefits of stablecoins, rather than focusing solely on stablecoins. There is often public confusion on this point. I am frequently asked whether J. P. Morgan is bullish on stablecoins or crypto. Deposit tokens offer most of the benefits of stablecoins, apart from the more lenient "know your customer" (KYC), which is not important to wholesale banks and the institutional client base.

Tokenized deposits on a public chain are preferred to stablecoins as they offer bank-grade risk management, including deposit insurance, anti-money-laundering (AML)/KYC, regulatory certainty, legal precedent, interest-bearing, and ease of use on distributed ledger technology (DLT) rails with on/off ramps almost at will. J. P. Morgan needs to be developing products that meet its KYC considerations, including intermediary KYC. This is the approach JPMorgan has taken with the instruments we are developing.

The key issue, as Adam Posen noted, is whether access to the central bank will become politicized. A risk to monitor is whether actors, with political ties in the stablecoin and crypto business, could gain implicit protection, even where only part of a mixed financial entity is systemically relevant.

ADAM S. POSEN

Adam S. Posen is the president of the Peterson Institute for International Economics.

Defining the dividing line between the Federal Reserve's monetary policy independence and its proper role in the financial system is where the rubber hits the road. This is true for both operational policy reasons and current political reasons, not to mention some of the reasons our legal colleagues spoke about on the previous panel. This is where the Supreme Court probably will define the extent of the limited carve-out for appointed Fed officials' independence from the president. If changes are made to the Federal Reserve Act via congressional action, then this is the policy area where they will be focused.

We can do better in setting out what the Fed should be allowed to do in the financial realm—in terms of asset purchases, discount window loans, bank supervision, and defining which financial institutions are systemic—and better than to just say it would be good for the Fed to do "whatever it takes" in a crisis. We all recognize that such crises occur, and a precedent for extensive emergency powers exists in many policy areas. The practical issue is more the Fed's day-to-day, month-to-month, year-to-year policies in financial stability. Ideally if properly designed, Fed independence, well used, would diminish the frequency and severity of financial crises and increase the ability to resolve them at lower cost when they do occur.

Independent monetary policy will not work without independent financial supervision. In practice, that rests on three points. The first argument for having the Fed or any central bank engaged in bank supervision and related financial regulation is informational. Central banks not only need to have knowledge in the building and experience with banks per se. Additionally, monetary policymakers need a certain amount of real-time intelligence both for the macroeconomic outlook and about the financial system as a system.

This is not satisfied by the microprudential information about specific banks' conditions. So, in March 2023, it was not just a question of whether Silicon Valley Bank or First Republic Bank were in trouble. The important questions were whether their troubles were a leading indicator of a sustained economic downturn? Would the impact be regional, sectoral, or systemic? What did this caution or update about the credit and investment indicators that the Fed uses to make its forecasts and thus set monetary policy?

One does not need to be George Stigler to recognize that regulators get captured and do not always get or transmit the proper information. That information does not necessarily flow well just because there exists something like the Financial Stability Oversight Council (FSOC) or a college of supervisors internationally. An independent Fed is less likely to be captured, particularly on

the information transparency and gathering front. Unless supervisors have some credible enforcement threats that they can pose to financial institutions, they will not get the needed information disclosed.

The second argument is that monetary policy cannot be separated from these kinds of financial assessments. Peek et al. (1999) show historically and econometrically the recurring importance of financial stability to Fed decision making. The simple fact is that most severe recessions are tied to, transmitted or amplified by, and usually caused by financial stability problems. There are very few severe recessions in the postwar US economy that were induced by monetary policy, even mistaken monetary policy, or by other things (the Volcker disinflation of the 1980s is an exception, but then the Savings and Loan Crisis followed and made it persist). In general, not just in the United States, a financial shock is required to have serious and persistent output fluctuations in a high-income economy.

Ultimately, both legally and politically, the central bank will be held accountable for financial stability outcomes, even if its remit is supposedly defined more narrowly to exclude some responsibility for (and capability to respond to) them. The central banks were created initially to be lenders of last resort, preventing panics and smoothing aggregate liquidity, and thereby preserving a stable value for money. They are the only institutions that can engage in unlimited liquidity provision if necessary.

The Bank of England found this out the hard way in the early 2000s when it spun out most bank supervision to the Financial Conduct Authority, deliberately trying to narrow its mission to monetary policy, more strictly defined; the Bank was left holding the bag in the 2008–10 financial crisis and ended up creating a Financial Policy Committee inside the Bank to complement the Monetary Policy Committee as a result. So, even if some Fed leaders want to keep plausible deniability, or some distance, from a financial issue that is really the problem of the Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation, it becomes the Fed's problem.

The third argument that monetary independence requires a measure of financial supervision independence goes directly to the ability to implement monetary policy. This is probably the most controversial point, but it is at least as important as the prior two. Monetary policy has always been about stabilizing the nominal economy through the policy manipulation of credit availability—the policy means of managing credit flows must adapt to the nature of the financial system at a given time. Legislation that fixates on restricting the instruments that the Fed can use to do that will lead to ineffective or failed monetary policies. Constraining instrument independence in this manner subverts the central bank's whole purpose, with substantial costs for the economy.

Some politicians and pundits critical of the Fed have built up a head of steam focusing on its means of executing monetary policy since 2008, notably its use of the balance sheet in quantitative easing (QE). But there is nothing new or radical about QE in either its form or its purpose. Central banks always need differentiated adaptations to financial developments to be able to properly transmit monetary policy. Right through the present day, there is great variation across economies over time in how their central banks implement monetary policy, with frequent instances of balance sheet usage playing a central role.

For a period from the 1960s through the 1990s, there was a belief that US monetary policy could be reliably and strongly transmitted solely by moving the federal funds rate, with the discount window available in emergencies. This reflected the partially deregulated US financial structure of the time, and in the 1970s and 1980s there were a lot of legitimate concerns—led from the top by Paul Volcker—that various financial and monetary innovations were eroding the transmission of monetary policy. Because things went smoothly for a while, probably for reasons having little to do with the instruments of monetary policy, a bunch of academic ex post rationalizations arose to argue that it was optimal conducting monetary policy solely through actions on Fed-controlled interest rates at the short end of the US Treasuries yield curve. That is the nature of how policies get justified by their adherents but is a major recurring cognitive error.

Thus, during the 2008–10 financial crisis, even when there was a common North Atlantic financial system at risk and coordination among central banks in easing monetary policy, the major central banks acted quite differently when having reached the zero lower bound on policy interest rates. The Fed conducted its version of QE on US Treasuries and on bonds of the federally guaranteed mortgage agencies; it was a political and legal nonstarter for the Fed to discount private assets (beyond specific kinds of bank loans) on anything but a short-term, crisis basis, for fear of distorting private markets.

In contrast, the European Central Bank (ECB) pursued a complete mirror image approach, given the different fiscal politics of the euro area: Government bonds could only be bought under strict controls in overt liquidity crises, to avoid fiscal moral hazard; the ECB actively sought out paper and distressed assets from private lenders to lend against. Simultaneously, the Bank of Japan and the Swiss National Bank did everything at once on very active balance sheets, conducting open market operations on corporate securities and foreign currencies, as well as both government bonds and private bank paper.

The period of mistaken belief in the ability to steer the economy effectively solely by short-rate setting falls into the category of nice work if you can get it. If a central bank has a financial system where simply and solely moving the discount rate has dependable, observable, reliable monetary transmission effects, great, but do not expect it to last. There is good reason why throughout modern monetary history there were periods where central banks used administrative guidance and various types of asset purchases to implement monetary policy, where you had things that looked like QE long before there was QE.

Legislators and advocates who are incensed about the Fed's use of its balance sheet, its ongoing use of QE (and quantitative tightening, or QT) long after 2010, or its acting upon the information it gathers through financial supervision when setting monetary policy, are fundamentally misguided. What the US economy demonstrated not just in 2008–2010, but in the COVID period, and now under financial innovation from blockchain, stablecoin and private lending is that interest rate setting is not enough to get the job done. In times of economic disruption, central bankers need to get their hands dirty and alleviate liquidity problems (shortages or excesses) in specific places in the macroeconomy. They have to monitor the transmission of monetary policy, which may be quite different this time around than it was last time around, rather than assuming that interest rate policy "gets in all the cracks of the economy" (Stein

2013). It does not, certainly not during crises or financial technology shifts, and probably only did for an interim as an accident of history (Posen 2012).

Effective monetary policy requires the ability to get into specific financial markets, and that requires a legislative definition of operational independence for the Federal Reserve broad enough for that purpose. As stated repeatedly at this conference, central bank independence is a means to an end. It is a proven means to good economic outcomes for Americans and for other people in the world economy. The surgeon or the airline pilot cannot do their jobs, for the well-being of their patients or passengers, if they are prevented from using all the effective tools in their surgical bags or control panels.

Similarly, Congress and the Supreme Court should not define central bank independence by the tools but instead define it by its utility and the outcome. If cases currently before the Supreme Court, or proposals from the current US Treasury, define Fed independence as the pure setting of interest rate policy, focusing on a recent instrument rather than the ability to affect the economy, those changes will undercut the very economic goals that the Federal Reserve Act mandates the Fed to pursue. For the Fed to pursue its mandate and serve the American people, it needs to maintain an active, independent role in financial supervision and regulation.

REFERENCES

Peek, Joe, Eric S. Rosengren, and Geoffrey M. B. Tootell. 1999. Is bank supervision central to central banking? *Quarterly Journal of Economics* 114, no. 2: 629–653.

Posen, Adam S. 2012. Making the most of doing more. Speech to the Barclays "Short end rates seminar," London, June 11.

Stein, Jeremy C. 2013. Overheating in Credit Markets: Origins, Measurement, and Policy Responses. Speech to the "Restoring Household Financial Stability after the Great Recession: Why Household Balance Sheets Matter" research symposium, Federal Reserve Bank of St. Louis, St. Louis, MO, February 7.

AMIT SERU

Amit Seru is a senior fellow at the Hoover Institution at Stanford University and the Steven and Roberta Denning professor of finance at Stanford's Graduate School of Business.

This session is titled Independence of Monetary Policy versus Financial Regulation and Supervision. For me, it is not a question of versus, but rather where independence must be preserved and where accountability must be strengthened. My remarks draw heavily on my own research and on the broader literature.

The overarching theme is simple: preserving monetary policy independence at the Federal Reserve requires credibility, and credibility requires governance. That, in turn, means making supervision more accountable.

Let me begin with why integration of monetary policy and supervision inside a central bank has appeal. Integration offers a holistic view of risks. It matters especially when the Fed must act as lender of last resort: Supervisory information helps distinguish insolvent banks from solvent but illiquid ones. Independence also offers insulation from political pressure and lobbying on supervision, just as it does for monetary policy. And, finally, integrated structures allow for faster, coordinated crisis responses.

But the very same structure creates tensions. First, financial-stability actions can end up constraining monetary policy, effectively "conflating" them. Second, supervisory lapses spill over reputationally to the institution's monetary-policy credibility.

The research suggests that coordination benefits during crises are real. But evidence on the Fed's ability to gain a genuine holistic view through integration is mixed, given several supervisory misses. I am also unconvinced that integration has meaningfully shielded supervision from politics. And on the tensions, both the conflation problem and the reputational problem have been operational, undermining the Fed's credibility.

A look at market beliefs underscores this. Many investors increasingly view the Fed's supervisory stance as tantamount to an across-the-board "too big to fail" (TBTF) guarantee. Banking becomes, in effect, an arbitrage: investors share in upside risks, and the Fed limits the downside.

Why do investors believe this? Because at moments of stress, the Fed's support has been both fast and broadening. Each time, the lender of last resort (LOLR) function is invoked. But the classical Bagehot principle is clear: Central banks are meant to support solvent but illiquid banks, not insolvent ones.

If the Fed treats every stress episode as a liquidity event, the LOLR becomes the lender of immediate resort. Intervention widens, TBTF expectations harden, and credibility erodes.

Preserving credibility, then, requires governance, "credibility governance." Independence must be earned through transparent, rule-aligned conduct. The rest of my remarks focus on three ways to do that: accountability, accountability, and accountability.

1. Accountability in the Lender-of-Last-Resort Function

The first step is ensuring that LOLR remains LOLR, not a blanket rescue facility. That requires using supervisory information to separate insolvent banks from solvent but illiquid ones. This is hard in practice. Measurement of solvency conditions is difficult, and crucially we have not defined guardrails around what constitutes liquidity versus solvency stress.

This ambiguity invites discretion. Without clear definitions, every event becomes a "liquidity" event. The problem is reminiscent of Heisenberg's uncertainty principle: without specifying what is being measured, interpretations shift freely. Here, the absence of criteria has given the Fed wide latitude to call almost anything a liquidity shock.

The consequences were clear in early 2023 when Silicon Valley Bank (SVB) failed. The Fed cast the episode as idiosyncratic, yet many other banks exhibited similar vulnerabilities. By framing the episode as liquidity-driven, the Fed opened the door for broad liquidity backstops and implicit protection for roughly $9 trillion in uninsured deposits.

Even with these interventions, banks continued to fail (e.g., First Republic Bank), and others remain troubled today such as Western Alliance Bank, Zions Bank, and others.

Why am I confident this was not a liquidity event? Because monetary tightening in 2022–23 created large, measurable mark-to-market losses on banks' long duration assets. In work with colleagues, using bank-level microdata, we estimated these unrealized losses to be roughly $2 trillion, about the size of the banking system's equity in early 2022. Importantly, more than 60 percent of this "turbulence" was in liquid securities, such as Treasuries. On the liability side, uninsured leverage, i.e., uninsured debt as a share of assets, proved critical in explaining fragility. We termed it "flight risk" for banks.

In figure 1, I plot turbulence on the y-axis and flight risk on the x-axis as of first quarter of 2023. Many banks, not just SVB, sit in the high-turbulence, high-flight-risk quadrant. Some are large, including a global systemically important bank (G-SIB) with more than $1 trillion in assets. Remarkably, two years after the turmoil, many of these banks remain in similar positions, sustained by central bank support.

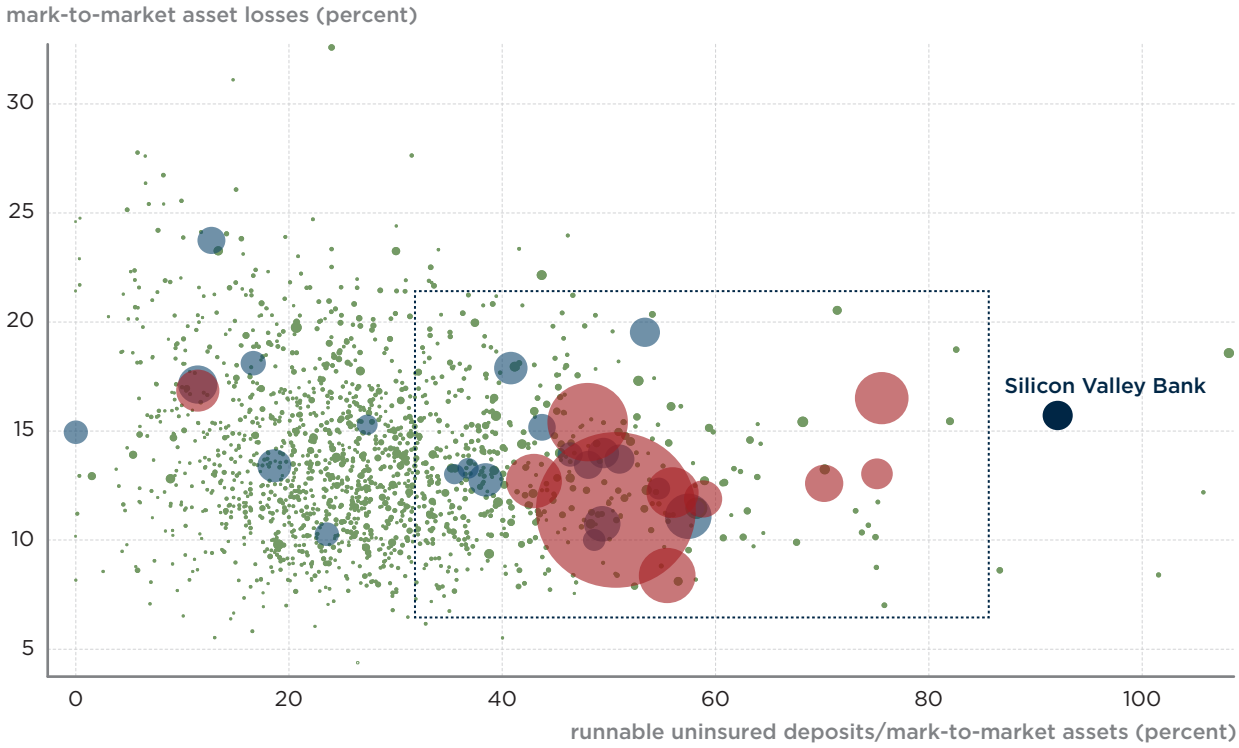
Why this hesitation to identify and resolve insolvent banks? One reason is discretion. Discretion can be useful, it allows expert judgment, but too much of it erodes accountability. Rules get reinterpreted as needed; the line between liquidity and solvency blurs.

2. Accountability in Supervision and Ratings

The role of discretion is stark in supervisory practices, especially in CAMELS ratings. These ratings—capital, asset quality, management, earnings, liquidity, sensitivity—drive deposit insurance assessments and decisions on bank expansion.

Figure 1

Turbulence (mark-to-market asset losses) versus flight risk (uninsured leverage)
Full set of insolvent banks if all uninsured depositors run



Notes: This figure plots the full set of "insolvent" banks. A bank is considered insolvent if the mark-to-market value of its assets—after paying all uninsured depositors—is insufficient to repay all insured deposits. The y-axis plots mark-to-market losses as a percentage of initial bank asset value. The x-axis plots uninsured deposits as a percentage of mark-to-market bank's asset value. Each dot is a potentially insolvent bank. The size of the dot represents the assets of the bank as of 2023. Banks with larger asset size are marked with bigger dots. Banks in the top right corner, where Silicon Valley Bank is, have the most severe asset losses.

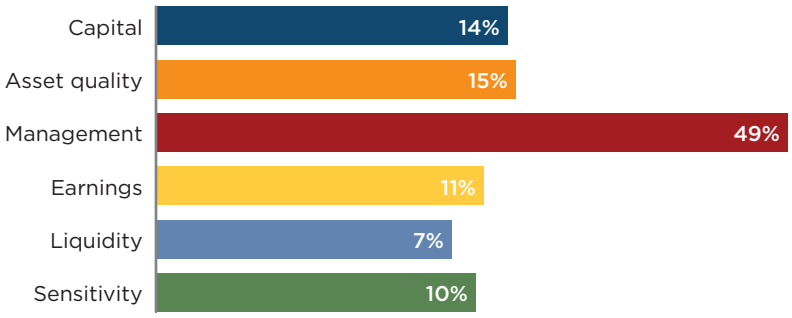
Source: Jiang et al. (2024).

In Agarwal et al. (2024), we study how each component contributes to the composite CAMELS rating. One might expect objective components to dominate. Instead, as figure 2 shows, management quality, a subjective measure, receives 49 percent of the effective weight. Discretion is built directly into the structure.

Now, discretion is not inherently bad in this setting as we find that each subcomponent does predict future bank health. But our study also asks what weights a machine-learning model (with guardrails) would assign if the goal were to optimize predictive accuracy. We find that requiring supervisors to follow even lightly rule-based weightings would produce more consistent and accurate supervision. In short: Discretion with rules outperforms discretion alone.

Excess discretion also enables avoidance of fundamental issues. High leverage is one of the simplest, most persistent drivers of fragility in the banking system: Small asset losses wipe out equity. The 2023 turmoil was exactly that. These vulnerabilities were predictable and manageable through higher equity buffers. And we know that higher equity need not suppress lending, as evidenced by nonbanks that operate with much more equity and rely heavily on uninsured funding.

Figure 2
Discretion in CAMELS ratings



Note: The figure is based on proprietary data. It shows the weight of each subcomponent in the composite CAMELS rating.
Source: Agarwal et al. (2024).

Yet the Fed once again in 2023 leaned on discretionary interpretations, labeling what were effectively solvency problems as liquidity problems. Industry groups seized this narrative to argue against higher capital in the Basel III endgame. The Fed's own post-SVB report largely framed the failure as liquidity-driven, inadvertently weakening its justification for stricter capital requirements.

3. Accountability in Responding to Innovation and Competition

Financial innovation presents another challenge where the Fed's behavior undermines its independence narrative. Fintech, payments, and private credit are rapidly reshaping intermediation, yet the Fed has been slow to adapt. Too often, its stance appears guided by industry rhetoric about risks to profitability and "stability," reinforcing the perception that it is protecting incumbents rather than fostering healthy competition. The central bank digital currency (CBDC) debate is emblematic: it is framed as a threat to banks rather than an opportunity to enhance competition and resilience. Innovation and competition are not dimensions on which the Fed is currently held accountable. But they should be, precisely because a central bank that is seen as shielding incumbents will struggle to sustain a credible claim to independence.

HOW ALL THIS CONSTRAINS MONETARY POLICY INDEPENDENCE

Do these supervisory choices—excess discretion, reluctance to take tough decisions, and generous use of LOLR—affect monetary policy independence? I believe they do.

As an illustration, I presented a simulation of how the number of banks at risk of runs rose with the 2022–23 policy rate hikes, under various commercial real estate stress scenarios. Above roughly 4.25 percent, the number of vulnerable banks increases sharply. This creates a de facto constraint: raising rates becomes intertwined with concerns about bank stability.

Why did we end up here? Because insufficient action was taken earlier to identify and resolve insolvent banks. Supervisory choices end up limiting monetary-policy space.

The Fed's structure demands an unusually high standard of credibility, and excessive reliance on discretion has undermined it. Addressing this requires meaningful governance reform—perhaps even institutional reorganization.

A GOVERNANCE PATH FORWARD

This clarifies responsibilities, reduces conflation, and allows the Fed to maintain the benefits of integrated information without blurring decisions. Ultimately, the Fed's independence is essential, but it must be earned. That requires aligning operations, procedures, and communications with its stated objectives in more systematic and transparent ways than today.

This structure clarifies responsibilities, reduces conflation, and preserves the benefits of shared information without blurring decisions. Ultimately, the Fed's independence is essential, but it must be earned—by aligning its operations, procedures, and communications with its stated objectives in far more systematic and transparent ways than today.

REFERENCES

Agarwal, Sumit, Bernardo C. Morais, Amit Seru, and Kelly Shue. 2024. *Noisy Experts? Discretion in Regulation*. NBER Working Paper 32344 (April). Cambridge, MA: National Bureau of Economic Research.

Jiang, Erica Xuewei, Gregor Matvos, Tomasz Piskorski, and Amit Seru. 2024. Monetary Tightening and US Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs? *Journal of Financial Economics* 159, article 103899.

DANIEL K. TARULLO

Daniel K. Tarullo is the Nomura Professor of International Financial Regulatory Practice at Harvard Law School. He served as a member of the Federal Reserve Board and the Federal Open Market Committee from January 2009 to April 2017.

In the abstract, we could just bottle up what Adam Posen has said and have a clear, affirmative answer to the question of whether the Federal Reserve should retain its financial regulatory functions. He and I may have a few nuanced differences, but I agree with all his basic points. Indeed, fifteen years ago his presentation would for me have been the easy answer to that question. Today, I find it a harder question, one that needs to be seriously discussed by those like myself who instinctively lean towards preserving a strong role for the Fed in financial regulation.

For many institutional arrangements, the optimal configuration at any time is not the abstract one we might have derived logically from first premises, but one that is heavily dependent on context. That is, it depends on the legal, political, economic, and other realities within which the institution operates. While it's neither feasible nor desirable to modify such arrangements every time there's a shift in that background context, sometimes the changes are consequential and persistent enough to warrant significant institutional change. For reasons I will identify a bit later, we now *may* be in such a moment.

First, let me comment on some of the traditional arguments for and against the merging of monetary policy and financial regulatory roles in the Fed or, really, central banks generally. Most of the relevant literature, by the way, offers these arguments in exactly the sort of decontextualized fashion I noted a moment ago. People often begin with what they think about their own central bank at a particular time and then abstract their observations to apply to all central banks at all times.

The principal arguments found in the literature against combining the two functions have been the possibility of a conflict of interest and the concentration of too much power to one institution. For the second, I have some sympathy. The Fed has, at least since 1951, been a very powerful institution. It not only sets monetary policy for the largest economy in the world. It is also at the center of responses to financial and economic crises, both domestic and international. While it has always been a bank regulator, its authority has been periodically expanded, as through the Bank Holding Company Act and the Dodd-Frank Act.

The conflict of interest concern is that the central bank may inappropriately set policy in one of its functions with an eye to achieving a certain end in its other function. That could be declining to tighten monetary policy when inflation looms in order to cover up regulatory mistakes that have left banks vulnerable to economic downturns or, conversely, forbearing from rigorous regulation of banks in order to encourage greater short-term credit growth. I understand the logic

of the argument, but I have to say I never observed anything close to this sort of thing happening during my time at the Fed. Perhaps it's been a problem in other central banks, but in the US context I really don't see it.

As to the arguments in favor of combining the two functions, as I've already noted, Adam Posen has offered an especially good rendition. Let me comment on two frequently mentioned arguments.

One is the point that monetary policy is intertwined with financial stability policy to such a degree that the functions should be lodged together in the central bank. There's something to this argument. If the central bank has means, such as authority to impose a countercyclical capital buffer, it has a possible alternative to raising rates when some classes of asset prices seem unsustainably inflated even as other parts of the economy would be unhelpfully slowed by an increase in interest rates. Some also argue that a central bank with microprudential regulatory authority can set regulations with an eye to the effective transmission of monetary policy. In the abstract, I see that argument, though in more than eight years of producing lots of bank regulations to implement Dodd-Frank, I observed such an interaction in only one case—the adoption of the enhanced supplementary leverage ratio.

The second traditional argument is the one I find especially powerful—the imperative of good information about the financial system being readily available to the central bank as a lender of last resort (LOLR). The LOLR function at the Fed is divided, legally and practically, into the discount window and other standing facilities, on the one hand, and the facilities established under the authority of Section 13(3) during periods of generalized financial stress. The operations of the discount window vary considerably from normal times, when usage of the window is minimal and the result of idiosyncratic liquidity issues at a small number of banks to stress times such as the spring of 2023, when many banks simultaneously come to the window.

On discount window operations in normal times, the argument for the Fed having regulatory authority is that it will better be able to determine expeditiously if the solvency of the bank seeking funds is such as to make it eligible for primary or secondary credit. If the Fed is the primary federal regulator for the bank, it will usually have pretty good real time information on the condition of the bank. Even if it is not the primary regulator, so the argument goes, its regulatory capacities will allow it to understand better the information on the bank it receives from the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC).

There's definitely something to this argument. Truthfully, though, when a single bank comes to the window in normal times, I suspect that consultation with the OCC would be an adequate, if somewhat clunky, way for the Fed to decide whether and on what terms to extend liquidity.

In periods of stress, on the other hand, the quantity of relevant information, and the stakes in getting that information quickly, are immeasurably higher, both with respect to insured depository institutions that are eligible for discount window borrowing and to the affiliates of those institutions in large bank holding companies that are heavily involved in capital market activities. Especially in the post-Gramm Leach Bliley period—with the emergence in the United States of what are very large, effectively universal banks—an ongoing familiarity with the operations and vulnerabilities of these institutions is essential for an effective

LOLR response. A crash course from the OCC at the onset of a crisis would not be enough to ensure the Fed was as well informed as possible in making decisions about its LOLR policies.

Not surprisingly, my quick review of the traditional arguments suggests an important regulatory role for the Fed, which—as I said—would have been an easy conclusion for me fifteen years ago. So, what has changed? Two important factors come to mind.

First, the Supreme Court's dramatic remaking of separation of powers doctrine, motivated by a strong unitary executive theory, has led the president to issue an executive order asserting control over the regulatory functions of the Fed. The order purports to except the Fed's monetary policy from administration control. But how would the order be enforced if the president felt the Fed's *regulatory* policies were going astray? The way executive orders are customarily enforced is through the implicit threat of removal of officials who defy them. But if the court would allow the president to remove a member of the Fed Board of Governors by simply stating an incompatibility of regulatory policy views, it is not clear that monetary policy independence would survive. The members of the board cannot, after all, be split into regulatory and monetary policy halves.

The second factor is the change in the political environment. Bank regulation has become not just more political, but intensely partisan. Before the global financial crisis, this was not the case. But during the legislative process that produced the Dodd-Frank Act, something just went bad. Since then, Democrats are largely on one side and Republicans on the other. As a result, there has been some erosion of support among members of Congress for monetary policy independence, because now when they think about the Fed, they think about regulatory policies with which they strongly disagree.

The combination of these two factors raises the possibility that the increasingly tenuous state of monetary policy independence is further endangered by the Fed's regulatory authority. There may be some intermediate institutional arrangement—perhaps some variation on the Bank of England's overlapping committee structure, adapted to US constitutional and organizational conditions. But that would surely require legislation.

If no such alternative arrangement is politically feasible, and continued monetary policy independence seemed to require removing the Fed's regulatory mandate, the outcome would not be a happy one. Much would be lost, including the considerable expertise that other parts of the Fed offer to its regulatory function, and most of all its capacities as a lender of last resort. The question for debate is thus not whether removing the Fed's regulatory authority is in and of itself desirable. It is not. The question is whether, all things considered, the benefits of maintaining it are outweighed by the costs to monetary policy independence.

CAROLYN A. WILKINS

Carolyn A. Wilkins is an external member of the Financial Policy Committee at the Bank of England. She is a visiting senior research scholar at Princeton University's Griswold Center for Economic Policy Studies, where she is a lecturer in the Department of Economics.

Central banks have earned independence through hard lessons, and it is being tested again in the United States after the post-COVID surge in inflation and debates over quantitative easing.

I will focus on three things: why operational independence matters for both monetary policy and financial regulation, how it differs across those two domains, and how we can reinforce accountability.

Given my role on the Bank of England's Financial Policy Committee, I will say that these are my views and not those of my bank colleagues.

By independence, I have a fairly conventional view. It is not a blank check, and it is constrained. It is the freedom to use legally grounded tools to pursue a clear public mandate, with strong accountability.

My role as a central banker for many years has taught me that independence supports two pillars of trust. In monetary policy, independence is a commitment device against short-termism. The cross-country evidence is familiar: more independence is associated with lower average inflation, and anchored inflation expectations. In prudential policy, independence is a guardrail against forbearance and capture. It is a means to resist the temptation to postpone tough decisions that are unpopular today but nonetheless cheaper for citizens tomorrow. It is meant to achieve this through greater financial resilience.

We tend to focus on the narrow set of benefits that central bank independence will buy us: financial stability and lower inflation. And we tend to forget what else it buys us in the United States: exorbitant privilege when it comes to the international use of the US dollar. The privilege is based on really old, boring things, such as confidence in the rule of law and faith in institutions.

That means what is at stake is even bigger than what this conversation tends to be about. Politicizing rate decisions or systemic risk regulation, sliding into forbearance, is a real problem for the United States. It is an even bigger problem today given concerns about fiscal prudence, about fiscal sustainability. That is a situation in which investors could make the United States pay for the risk in a bigger way than we have seen so far.

One of the worries that we talk about at the Bank of England in terms of financial stability are about fiscal sustainability and continued credibility of institutions.

Monetary policy and financial system policy differ in ways that are important for how you want to define independence and sustain it through accountability. And they are pretty obvious.

The first area of difference is objectives. Monetary policy objectives are pretty tight. They are less tight in the United States because there is a dual mandate: inflation and full employment. But nonetheless, inflation is observable, and full employment can be estimated. So, you can tie what the central bank is trying to achieve to a short list of things, and you can ex post, ideally, tell whether or not it did a good job.

I prefer a single mandate, such as flexible inflation targeting. Research shows that you can get close to the same outcomes in terms of welfare by doing that. And I think it makes it simpler from a communication and an accountability point of view. But either way, you have a public contract with the citizens you serve that can be verified.

Financial system policies, on the other hand, pursue multiple goals, including safety and soundness, and consumer protection. Success is actually probabilistic. And nowhere is, "well, nothing happened," a key performance indicator. And so, it is tricky that way.

The time horizon is different as well. With monetary policy, yes, there are lags. But at least you get interim views on what is happening with inflation. You receive data. With respect to prudential policy, what usually happens is a whole lot of nothing. And even if something is happening in that vulnerabilities are building, as we saw before the global financial crisis, those take years and years to develop. It is often like boiling the frog on the regulatory side when things are going wrong.

Another area of difference relates to the fiscal perimeter. With respect to monetary policy tools, the federal funds rate is straightforward and is accepted. However, extraordinary monetary policy tools can blur into fiscal territory. They also have implications for the distribution of income. There are winners and losers with extraordinary monetary policy tools in a different way than with the fed funds rate.

In the case of prudential tools, it is even more complicated because they are more granular, they are more legalistic. Here, independence lies in the details, the calibration of say capital buffers or stress test design or supervisory findings. This can be, naturally, more political. That is why accountability and transparency are even more important.

I have a short list of ideas to support central bank independence in these two arenas. I will say up front that I realize that they are not comprehensive, but rather some practical reinforcements.

Starting with monetary policy, the framework review that was done last summer went in the right direction by moving away from the open-ended makeup strategies and clarifying how the balance between employment and inflation goals was being made.

I understand why the Federal Reserve had wanted to privilege the zero lower bound problem in its previous framework. However, it turned out to be a strategy that was not robust to different shocks. It also made it even harder to understand what exactly the Fed was trying to achieve and over what time horizon. That is not a good feature for a delegated authority, in my view.

More could be still sharpened, though. I really like the way that Carola Binder put it in the previous panel. She emphasized the importance of making sure that policy measures that are being taken to achieve central bank mandates are viewed as being legitimate.

My ideas have this principle in mind. The first is to make the dot plots more informative about the policy reaction function. Right now, the published interest rate projections are not linked to each participant's forecast for inflation and unemployment. A matrix could show, in anonymous form, how each participant's expected unemployment, inflation, and policy rate outcomes line up. I think being transparent about that is important to judging, ex ante, whether or not the deviation from, say, a Taylor rule can be explained by the underlying forecast that they have in their head. It would give markets and Congress a clearer sense of how these reaction functions differ among members, without politicizing staff analysis.

A second idea that would reinforce legitimacy of policy actions would be to institutionalize the governance around the nonstandard monetary policy tools. I would not just recommend this to the Fed but to other central banks as well. In fact, it was part of our recommendations in the RBA review in 2023. This would include a public framework to assess comprehensive net benefits over time, related to the economy, the fiscal situation and financial stability. There is analysis that exists today, but it is mostly partial, ad hoc and ex post. I think a comprehensive framework would help discipline decision making and legitimize and explain how decisions are taken to use the extended monetary policy toolkit.

Finally, in renewing the monetary policy framework, both with respect to the objectives and the tools, there should be a bigger independent, external element that the Fed does not control. Right now, it looks like they are setting and grading their own exam every five years. I know firsthand that countries such as Sweden and Australia have held constructive external reviews.

How to do better on regulation and supervision? Here, the challenge is institutional clarity. Concentrating powers inside a central bank can yield synergies but also blur accountability. What matters most is clarity of mandate, disciplined coordination, and accountability.

Given my experience, I think the Bank of England offers a strong benchmark. Power is more concentrated in the United Kingdom than in the United States, but governance boundaries are crisp. The Bank of England's Monetary Policy Committee, Financial Policy Committee, and Prudential Regulation Authority each have separate statutory remits. And there are clear links to the executive that can give a steer, but respect operational independence. For example, the committees receive periodic and public remit letters from the Chancellor of the Exchequer, and HM Treasury has a nonvoting member on the Financial Policy Committee. This set up is helpful in peace times, but also in times of stress.

A good example is how the Financial Policy Committee handled the UK liability-driven investment episode in 2022. The actions that were taken to restore market functioning needed to be coordinated across monetary policy and financial stability. That is because the Financial Policy Committee wanted the Bank of England to buy bonds for a short period of time, while the Monetary Policy Committee wanted to commence quantitative tightening. The Bank's governance structure made coordination seamless. In the end, central bank independence and the credibility that the Bank of England had in terms of its inflation mandate made that targeted intervention successful. The strength of the team also mattered a lot, as did the clear governance and the clear legislation that underpinned the policy actions.

In the United States, prudential oversight remains fragmented across the Fed, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and multiple state and federal agencies. That patchwork raises costs, leaves potential gaps, and blurs accountability. We saw this with the Silicon Valley Bank (SVB) failure in 2023: supervisory findings were slow to escalate, and coordination between agencies was uneven. The Financial Stability Oversight Council (FSOC) is meant to coordinate, and the Office of Financial Research (OFR) to supply systemic data, yet integration across agencies is incomplete. The OFR and others have already flagged overlapping mandates and weak cross-agency coordination.

There are practical reforms that could reinforce effectiveness. The first is to clarify and strengthen FSOC's systemic risk mandate, and the incentives of its members. Several member agencies still lack a systemic risk mandate of their own. As Donald Kohn (then vice chairman of the Board of Governors of the Federal Reserve) said over a decade ago, unless incentives are aligned, coordination will always be fragile.

The second is to institutionalize coordination. Create formal mechanisms for data sharing, joint scenario exercises, and macroprudential reporting. These should be anchored in statute rather than personalities.

My last idea is maybe the most obvious. If you are going to strengthen independence anywhere, it has to be where it matters the most. And I think where the forbearance risk is the highest is with respect to examiner autonomy, model validation teams, and stress testing design. All those things are really subject to risk of forbearance or temptation to delay action, and political pressures.

The best defense of central bank independence is disciplined practice: stay within clear mandates, deliver results, and strengthen the framework through transparency, governance, and accountability.

V. Policymaker Experience with Independence in Practice

CHARLES L. EVANS
ROGER W. FERGUSON, JR.
THOMAS HOENIG

CHARLES L. EVANS

Charles L. Evans served as the ninth president and chief executive officer of the Federal Reserve Bank of Chicago, from September 2007 to January 2023.

The theme of this panel is policymaker experience with independence in practice. Independence in practice, to me, means being able to do what it takes to achieve the central bank's mandated objectives. Somebody referred to this as operational autonomy. Fine.

An essential element of being responsible in acting with independence is that central bankers accept criticism from everyone. This is important. Criticism is important for stress testing ideas and strategies. It should be welcomed. Central bankers should have thick skins. And it is a critical guardrail for avoiding groupthink.

Now, in practice, independence is most critical during stressful or emergency situations. Is there trust? Carola Binder's comments are a useful contribution to understanding these issues. Building public trust, maintaining trust, and repairing diminished trust is a 365-day-a-year job. I believe in voluntary exchange, where the public likes what the Federal Reserve is doing. The alternative almost amounts to coercion, where they just force Fed policies on the public no matter what. Of course, it does work that way. The Federal Open Market Committee (FOMC) must act to achieve its dual mandate objectives, so an important complementary activity is to communicate, communicate, and communicate.

Fed Chair Powell clearly understands this and begins every press conference with, "My colleagues and I remain squarely focused on achieving our dual mandate goals of maximum employment and stable prices for the benefit of the American people." Elsewhere, when decisions were more difficult (e.g., the 75 basis point interest rate increases in 2022) he has added, "Everything we do is in service to the public." I am a big fan of that. Public trust that the Fed will do the right thing for everyone, is crucial.

Also, Congress greatly understands and cares about their constituent views. I thought Patrick McHenry was terrific in getting that point across earlier. Congressional representatives know very well what their constituents like and don't like. He nailed that. This is important to appreciate during controversial or difficult episodes in Fed history. In the period 1979–82, Paul Volcker raised short-term interest rates to as high as 18 percent. It wasn't popular. Builders mailed two-by-fours to the Fed with a note, "We can't use these anymore. Maybe you can."

In the period 1988–89, Alan Greenspan raised the federal funds rate to 9.75 percent to reduce inflation. My first 30-year mortgage in 1989 was 10.5 percent. That wasn't popular. Ben Bernanke and Janet Yellen, from 2009 through 2015, maintained the target range for the fed funds rate at zero to a

quarter percent for seven years. The FOMC also expanded the System Open Market Account (SOMA) balance sheet during the quantitative easing (QE)1, QE2, maturity extension program (MEP), and open-ended QE3 programs. Interest rates on CDs were not much above 0. My wife is a saver and complained about that all the time. In doing my Fed job, I had to exercise additional personal independence when I advocated for more accommodation, not less. None of that was popular. In each of these cases, monetary policy was focused on achieving maximum employment and price stability. Two percent, most recently, that's the job. Just do it.

Public trust is crucial and always at risk for central banks. It must be in the job description, just think about the folks at the first and second national banks.

I was going to display a chart from the University of Michigan Survey of Consumers that breaks out inflation expectations by political party identification. But Carola Binder discussed her excellent research on these public trust issues and the partisan inflation expectations. Just to remind everybody, there are different views by partisan positions, identified political party. Why is that? Why is policy affecting people differently as identified by party affiliation? Or is it the way that information is massaged, delivered and received with perhaps partisan spins? As Binder said very well, central bank legitimacy may be on shaky grounds. Clearly, there have been past historical episodes when that was a first-order national problem.

Given the disparate beliefs in the public and the historical unpopularity of central banks, effective and resonant communication is valuable with the public. I didn't really intend to come here and be parochial about the important role of the Federal Reserve banks as a retired Federal Reserve bank president. I knew that Thomas Hoenig could do that very well for all of us. And Paul Tucker said the same thing about the Bank of England and Governor Andrew Bailey's important communications role. There is great value for the heads of central banks to be out there speaking in all regions, with visibility and regularly. I know that Adam Posen as a Monetary Policy Committee (MPC) member gave many speeches. I think that is really important. All policymakers should be speaking nationally with public audiences to communicate and explain.

Of course, economists are often most comfortable discussing more technical aspects of policymaking and rules. These are topics that sometimes only economists love. And people who must pay attention to all policymaker communications, no matter what. Well, that's great for economists, but I think going out and talking in plain language terms is really important, too.

Over the years, Fed policymakers have relied on a few different commentaries to display their understanding and empathy for the challenges that the public faces from economic weakness and uncertainty. And to counter criticisms of elite, out-of-touch viewpoints. One of these themes is to emphasize Main Street issues, challenges for small businesses, and everyday household budget challenges in making every dollar stretch further. It sharpens things a bit to say, "We're really here for Main Street, not Wall Street, or not just Wall Street." That's a standard page in the communications playbook.

Another theme revolves around inclusivity (as opposed to exclusivity). I didn't think this would be controversial, but I guess it has been. The communications theme is to state that the Fed's goals encompass broad and inclusive employment. Inclusive runs the gamut across all sectors of the population: all

income levels; all education levels; all geographic locations, like urban, suburban, exurb, rural; female, male, and racial groups. I don't see why that's controversial. The ideal aspiration must be that monetary policy actions benefit all and are universal. Of course, ensuring that all benefits are shared evenly isn't feasible with a single, blunt instrument like the fed funds policy rate.

Improved rhetoric can be more effective, but monetary policy has many limitations. And the public is well aware of this. No one is fooled by the clever rhetoric that many of us have used over many, many years. What do we say? "We raise the funds rate today to ultimately ensure a strong labor market." "Price stability is a foundation for strong labor markets." Yes, I do believe that. Price stability is important.

But what's unstated? The subtitle is silent. The unemployed are soldiers in the battle against inflation, and all will be better when the troops come home. That's really what that's saying. Again, no one is fooled. We need to explain that. Lawrence Summers noted that many regional Fed presidents speaking so much sound like a confusing cacophony. But one man's cacophony of viewpoints expressed by many policymakers around the country may be another person's communication with many that is really sorely needed. I'm a big fan of that approach. I thought that President Neel Kashkari made some important comments earlier at this conference in support of that view, too.

Delivering on mandated goals is critical when so much pain and suffering may be inflicted on the public in the task of achieving stable prices and maximum employment. Being able to do what it takes, that is independence in practice. Central bankers have to be able to do that. But the current environment is awash with conflicting information and worse. Understanding these information gaps is really key in addressing them in a meaningful way for everybody.

ROGER W. FERGUSON, JR.

Roger W. Ferguson, Jr., is the Steven A. Tananbaum Distinguished Fellow for International Economics at the Council on Foreign Relations and the immediate past president and CEO of TIAA. He was vice chairman of the Board of Governors of the US Federal Reserve System. He serves on the PIIE Board of Directors.

I am actually going to take the same theme of independence, et cetera, but through a different angle, which is the importance of a Federal Reserve that operates independently during a crisis. We haven't talked very much about it, but I do not want to take it for granted that the ability of the Fed to do what it must during a crisis without looking to the White House or to the Treasury is incredibly important.

In some sense, it's obvious that during a crisis, the central bank acts independently. But in fact, it should not be taken for granted that the central bank is a separate power independent from the executive branch or the legislative branch, but acting under the rules of the legislative branch. As some of you know, many of you do not, I happened to be the only Fed governor in Washington on 9/11. Therefore, I will review the Fed's response to the terrorist attack on 9/11 as a case study for central bank independence.

I raise 9/11 as a case study because during the course of that day, we made a large number of decisions without looking to the White House, the Treasury, or others for guidance. We acted boldly and decisively, but did it comfortably, recognizing that, should it come out well or poorly, Congress would review us and come back with suggestions.

With the knowledge that we didn't have to ask "masters" for approval before we took action, the Federal Reserve in Washington and around the country jumped into action almost immediately.

I mean, almost immediately. The second plane hit the second building around 9:06 or 9:07 a.m. By 9:45, half an hour, 45 minutes, an hour later, the Federal Reserve had issued its first statement, not a big public statement, but a private statement.

That statement was addressed to the banking industry and stated that our large dollar payment system called Fedwire, and it sounds pretty technical and arcane now, would "stay open until all transactions were settled."

Such boring language. What does that mean? What it actually meant was that the large dollar payment system on which everything else relies for liquidity would be available. We did not have to go down to the Treasury Department or the White House to ask for their approval. We acted on our own authority and independent of any other governmental authority.

In fact, the White House had told everyone to evacuate Washington, DC, and we chose to do something different from that. We decided, as an institution, an independent federal institution, that we would stay open and operating. Many in this room were there, many were there when that decision was made. This

decision was made against the clear expectation that the federal government would shut down. We said it because, to Charles Evans's point and others, we have an important obligation as part of the government, but in fact exercise our authority somewhat independently of the rest of the government.

The decision to stay open and operating was one that had to be discussed internally. Some of the Federal Reserve bank presidents said no, some said yes, some said maybe, but in the end we reached a very quick consensus that we would stay open and operating.

During the course of the day, a number of debates came up. There were several debates. The one that sticks most to my mind was: what should we do about commercial banks? Some people in the administration, direct reports to the president or one removed, sub-Cabinet officials, called me and suggested that we should declare a banking holiday.

Fortunately, the Fed and the Office of the Comptroller of the Currency (OCC) ultimately have the authority to recommend to the president what we should do, not take directions from his Cabinet and sub-Cabinet officers, and we made an independent decision that we would not declare a banking holiday or not recommend that to the president. The decision to declare a banking holiday is ultimately the president's, but it was based on the recommendations from experts around him. The Fed's decision not to support a recommendation for a banking holiday proved in hindsight to be the right thing.

We can talk about the value of banking holidays—what we know about what happens—but one of the things that we certainly know is announcing from the White House that we're going to close the banks would certainly have increased, not decreased anxiety and uncertainty. And we know that the ability to open banks after they're closed is also a highly risky proposition during what was clearly going to be an uncertain time.

So, then we also had another major question, which was: how do we deal with the dollars overseas? We decided on our authority, no one else's, that we would lend quite freely, frankly, to other central banks—the Bank of Canada, Bank of England, the Bank of Japan, and the European Central Bank—through a series of swap arrangements and other things.

All of this led to something that has now become regular part of the Fed's toolkit. We actually, by explicit policy decision, expanded the size of the balance sheet quite significantly. One of the first times that that tool was used very explicitly. Some of the folks in monetary affairs and others came to remind me that that would be an outcome of such a massive extension of credit. My response was to remind them that an expansion of the balance sheet is required to provide "an elastic currency."

And we undertook that because it was the right thing to do.

And so, I tell you this story just to say the ability of a Fed to be highly confident of making decisions, even when the rest of the government is very uncertain about what to do, has proven to be very helpful in times of crisis as well as in the usual ways that we talk about in keeping inflation under control. There's nothing wrong with that. That's the day-to-day operation. But imagine the highly unusual operations, such as a national crisis, and think through what it means to have a central bank that can confidently make decisions without seeking prior approval from the Executive.

Having said it, let's also be clear that at the end of the day, the Fed is an instrument of the legislative branch. We've heard, I don't know how many times, the Fed was created by an Act of Congress in 1913, modified in 1935. Therefore, our ability to do the things that Fed does is also dependent on legislative review and approval.

What we've seen is, as always happens, once these acts are undertaken, then Congress has a very important chance to look back and assess or even second guess what was done well and what wasn't done so well.

After 9/11, one of the things that Congress recognized was that we had then a very vulnerable and weak payment system, particularly at the retail level.

At that point, the Fed was clearing millions of pieces of paper, little pieces of paper that some of you remember well, your children and grandchildren do not, they're called checks. So, the Fed was responsible then, as it is now, ultimately for clearing all the checks in the country.

They did that through flying these little pieces of paper around at night through a leased fleet of airplanes. And Congress realized, based on advice from the Fed, that we should work really hard to modernize the retail payment system.

Out of that came, the so-called Check Clearing for the 21st Century Act. In essence Check 21 made the image of the check sufficient for clearing the check, resulting in "remote capture" at the ATM or through the "smart phone." It has led directly and indirectly to the ability to pay online, for example, and to do online banking. It modernized the use of the ATM to use images of the check as the final instrument on which you could do clearing and final settlement.

We've also seen in other cases when postcrisis, Congress looked and said, well, we aren't sure we like the way the Fed has handled some of those tools. And so, post 2008, Dodd-Frank made changes to the way the Fed operates because of Congress's assessment post-crisis that the Fed could improve its operations.

So, as an example, the creation of the Vice Chair for Supervision was a clear effort by Congress to say, we need someone at the Fed who is thinking about supervision, perhaps not independently of monetary policy, but with a unique responsibility for that role. Before Dodd-Frank, bank supervision was shared across the board, with different Fed governors leading the efforts.

There have also obviously been some efforts to change the way the emergency lending and lender of last resort are used. Maybe right, maybe wrong, but Congress has limited the Fed's 13(3) emergency lending authority to exclude emergency loans to single, specific firms. Congress also required the Secretary of the Treasury's approval for any new emergency lending program.

To conclude, we are in a moment where some people think Fed independence is their number one priority. I understand that some have said it's not one of their top 100 priorities.

The common discussion is the recognition that Fed independence plays a role during the normal times of fighting inflation. I've tried to bring to you one dramatic case in which the ability of the Fed to make decisions independently of the rest of the government proved to be critical to balancing and maintaining stability in the financial system.

THOMAS HOENIG

Thomas Hoenig is a Distinguished Senior Fellow at the Mercatus Center at George Mason University. He served as vice chairman of the Federal Deposit Insurance Corporation from 2012 until 2018 and president and chief executive officer of the Federal Reserve Bank of Kansas City and a member of the Federal Reserve System's Federal Open Market Committee from 1991 to 2011.

My comments are on "Fed independence: Theory versus practice." I'm going to raise concerns about Federal Reserve independence looking forward, based on its practices over the past several years. But in doing that, I want first to outline how I think about the theory and purpose of Fed independence.

The Fed's legislative mandate is to pursue stable prices, maximum employment, and moderate long-term interest rates. In its pursuit of these goals the Fed is designed to be insulated, or independent, from short-term political control and influence.

In theory, when the economy is growing too slowly or below potential, the Fed can lower interest rates, as it judges necessary, to stimulate the economy to bring it back to potential. That's the easy part of independence. When inflation is increasing, or threatening, because of too rapid credit growth or related factors, the Fed can raise rates to slow the economy to bring it back to normal. That's the harder part of independence, at least in my experience, that's the case.

When there's a crisis, a liquidity crisis for example, the Fed provides a temporary liquidity facility to preclude a possible collapse of the system. But then quickly, as quickly as possible, the Fed is expected to remove the stimulus and return to more normal policy and turn the economy back to the private sector.

In practice, unfortunately, the Fed often doesn't follow the theory fully, and that's concerning. Over time, in my opinion, an independent Fed, with a wink and a nod from Congress and the administration, has broadened its interpretation of its mandate to deepen and extend its role within the financial economy and fiscal policy.

Over time, the Fed has engaged in fiscal activities for Congress and has become an essential support in underwriting the Treasury's debt issuance. This evolution toward fiscal policy is well illustrated in the way the Fed operated after the global financial crisis in 2008, and after the pandemic in 2020.

Well after the global financial crisis and the pandemic, the Fed continued its use of large-scale asset purchases of government and government-guaranteed debt, so-called quantitative easing (QE). This exceptional policy became one of the Fed's standard operating tools, teaching Congress and Treasury that it was a ready buyer of the federal debt. In this role it also suppressed interest rates, enabling the government to spend and borrow more easily while keeping its borrowing costs down. The Fed quickly dominated the Treasury debt market, weakening the role of the bond vigilantes in controlling the government's propensity to spend and borrow. This extended reach served to reward leverage and penalize savings.

The Fed also purchased non-Treasury securities during the crisis and still holds them today. Most of these assets are mortgage-backed securities, in which case the Fed is directly supporting the housing market. While perhaps well intended, such support is not within the Fed's mandate. It is the responsibility of Congress.

In 2019 and 2020, the Fed again engaged in large-scale asset purchases to support a highly leveraged government securities market that ran into difficulty from a significant temporary spike in the securities repo rate. The purpose of the Fed's intervention was to keep the Treasury market calm and operating smoothly, and to avoid economic volatility. It is noteworthy that the temporary liquidity intervention continued into 2020, well after the September 2019 event.

And now the Fed provides the banking industry with a standing repo facility. This facility is a substitute for the discount window and is much easier for banks to access. It may be accurate to say that the facility makes the Fed the lender-of-first resort, the goal being to keep the Treasury market functioning smoothly, highly liquid, and very elastic for an ever-larger Treasury debt market.

Thus, my concern is that these Fed actions have left in their wake a less independent central bank, less accountable market, and a less accountable government spending program. There is now a deep-seated expectation on the part of Wall Street, the Treasury, and even within the Fed, that the Fed must intervene to maintain asset values and smoothly functioning securities markets. Through the Fed's expanded interpretation of its mandate and the expectation of support for Treasury and market participants, the Fed's duties now include certain fiscal responsibilities.

As the Fed has expanded its mandate, it also implicitly accepts the tradeoff of higher inflation in assets and consumer prices in exchange for a calm, reliable treasury market. For example, the Fed just lowered its policy rate although inflation remains at 3 percent, well above the Fed's 2 percent target and price stability. Also, it appears that Congress and the Fed have implicitly accepted a significant redistribution of wealth within the nation as the Fed has suppressed interest rates, favoring debtors and leverage over savers.

To get a further sense of the effects of the government's growing debt and Fed's expanded mandate, here are some economic trends between 2005 and 2025 to take note of:

- Nominal GDP has increased 2½ times from less than $13 trillion to over $30 trillion, while real GDP has increased only 1½ times.
- The consumer price index (CPI) has almost doubled, 1.7 times.
- Real weekly earnings, wages and salaries increased only 1.2 times over that same period.
- The gross federal debt has increased nearly 5 times, from about $7.9 trillion to about $38 trillion.
- The Standard & Poor's 500 index increased 5½ times, even more than government debt.

These outcomes reflect a compromised Fed, a less independent Fed, less able to resist Congress's spending and Treasury's need to fund the accelerating debt at low interest rates. Quantitative tightening (QT) is over. QE is returning

soon. Throttling back inflation, including asset inflation, to meet its stable price mandate will be increasingly difficult for the Fed to achieve. And so will its ability to achieve its mandate of long-term maximum employment.

The Fed must carefully think about these trends and what they imply for it going forward. It has compromised its independence. The Fed now confronts the challenge of fiscal dominance. The United States will add another $2 trillion of debt to its balance sheet in 2025 and into the future. Someone must fund it, and the Fed has a history of being that someone. Thus, pressure will only build for it to monetize future debt. How can the Fed insist that it owns something, independence, when it appears to have given it away?

So, what can be done? Well, the United States has been in this position before. After World War II, it had a similar problem. The federal debt was over 100 percent of GDP. Treasury wanted the Fed to keep interest rates low to keep the cost of the federal debt low. At the same time, the Fed was having to deal with rising inflation. The conflict between the Treasury and Fed was tense, so much so that President Harry Truman called the entire Federal Open Market Committee (FOMC) to the White House to resolve the conflict. Ultimately, a compromise was reached in the form of the Treasury-Federal Reserve Accord of 1951, which reestablished the Fed's independence.

It is time for a second Fed-Treasury Accord. Such an accord doesn't have to shock the economy, it can be understood to involve multiple years, in which the government brings down federal deficits from their current level of nearly 7 percent to 2 or 3 percent of GDP. This would allow for the country to grow out of its debt dilemma, for the Fed to remain independent, and for its policies to not be overwhelmed by fiscal demands.

To give you a picture of how this could evolve, consider the 10 years following the 1951 Accord. The debt-to-GDP ratio fell from 90 to 55 percent. Fiscal deficits averaged around 2 percent of GDP. Real GDP growth averaged nearly 4 percent while inflation averaged less than 2 percent. Such outcomes benefit all.

I realize that today's economy is much different than it was in 1951. But the problem is the same, isn't it? Spending relative to revenues remains a problem and deficits remain large. Demands on the Fed to print money are threatening its independence, making it subservient to the Treasury's funding needs. This requires a new Fed-Treasury Accord.

Can we get it? We must. It will take time and explanation, but the Fed, Congress and administration cannot confine their outlook and goals to just the next quarter's inflation and employment numbers. They must think within a real long-term context and framework.

PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

1750 Massachusetts Avenue, NW
Washington, DC 20036-1903 USA
1.202.328.9000
www.piie.com

ISBN 978-0-88132-759-5
90000
9 780881 327595