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Central Bank Independence

John H. Cochrane¹

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HOOVER INSTITUTION
434 GALVEZ MALL
STANFORD UNIVERSITY
STANFORD, CA 94305-6010

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Central bank independence is not an absolute virtue. The Federal Reserve cannot be completely independent and print money to use at it sees fit. Independence is constrained by a limited mandate, limited tools, and by accountability. Independent central banks are constructed by governments, to help those governments precommit to good long-run policies. In the near future, the precommitment to repay government debts rather than inflate them away will figure more prominently than the tension between inflation vs. unemployment that has been prominent in the past. Since central bankers face the same temptations as politicians, the limitations of a well-constructed mandate are more effective precommitments than independence with freedom of action. Complaints about the Fed's expanded activities are also better addressed by renewed attention on its limited mandate than by attacking or enhancing its independence.

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¹ Hoover Institution, Stanford University, NBER, and CATO. johnhcochrane.com; john.cochrane@stanford.edu.
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1. Introduction

Central bank independence is not an absolute virtue. Our constitutional order does not countenance a completely independent agency that creates money to use as it sees fit. Fed independence is limited and constrained by accountability, a limited mandate, and limited tools. The question for us is how to restructure that overall package.

The Fed has over time greatly expanded the scope of its activities. It has stepped into fiscal and political territory usually reserved for more politically accountable agencies, and it has presided over embarrassing institutional failures. Reform must come sooner or later.

We face a choice: The Fed could remain an expansive, powerful, and political agency, 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 raise the drawbridge, hoist the independence flag, and defend the status quo is not going to be tenable for long.

I survey the economic rationale for independence and some of the historical experience. Only the package of independence and limitations surmounts the central precommitment problems of monetary policy and financial regulation. At the moment, restructuring the limitations is more important for successful reforms than greater or lesser independence. That is especially true for the two central problems we will face going forward: Fiscal pressure on monetary policy and finally fixing financial regulation.

Independence is in the news following President Trump's desire to fire FOMC members and regional Federal Reserve Bank Presidents, as well as to pressure the Fed to lower interest rates. But the issue has been simmering, partly in response to the Fed's expansion of activities. I am not alone. Many legal and economic scholars are reexamining the foundations of the Fed, and I try to incorporate their arguments.

2. Independence and Limitations

The Fed is not absolutely independent. Fed officials are appointed by the Administration, confirmed by the Senate, serve limited terms, and must regularly report to Congress. The Fed has a limited mandate, featuring "price stability" and "maximum employment." Implicit is, "and nothing else." A central banker may feel that reshoring manufacturing or stopping climate change are vital government priorities, and a river of money or forcing banks to act would help. But an independent Fed must leave these issues to Congress, Administration, or other agencies. The Fed's tools are limited. Traditionally, it only set overnight interest rates, not interfering in other asset markets, and purchased only Treasury debt, at least outside of crises. The Fed may buy and sell, borrow and lend, but it may not hand out money. It only transacts with banks and a few other large qualified financial institutions.

These limitations are striking when you think about them: The Fed is charged with controlling inflation. The most powerful way to create inflation is to print money and hand it out. The most powerful way to stop inflation is to confiscate money. The Fed is forbidden these most potent tools. It must instead nudge inflation via overnight interbank borrowing rates. The Fed is charged with maximum employment. Yet the Fed may not lower marginal tax rates, improve schools, fix social program disincentives, remove minimum or prevailing wage laws, stop

immigration, or, if your tastes run the other way, subsidize hiring and schooling, empower unions, ramp up anti-discrimination enforcement, increase minimum wages, open immigration, or just print money and hire people as the Modern Monetary Theorists advocate.

Why does the Fed face these limits? Well, taxing, spending, and regulatory policies must be reserved for politically accountable parts of government. Fiscal policy— handing out money or confiscating it — may be a powerful engine of inflation and disinflation, but fiscal policy transfers wealth. Taking wealth from A, by force, is political. Granting wealth to B—and not to C—is political. Telling banks who to lend to and who not to lend to, allowing or disallowing whole business models, is also political. In our democratic order these kinds of decisions must be made by politically accountable branches of government, imperfect as they are, and subject to their own legal and constitutional limitations.

The tools of conventional monetary policy do not directly transfer wealth. Our independent central bank may set short-term interest rates; it may borrow and lend, at plausibly market rates; it may buy and sell, always receiving something of value in return for money given out. But it may not transfer money or confiscate money. It may not too directly and independently tell banks who to lend to and at what rates. (Congress does a lot of the latter via the Fed, but the Fed may not initiate too much directed lending on its own accord.)

Yes, monetary policy creates winners and losers. Inflation and low real interest rates help borrowers, home buyers, and the government, hurting savers and government bondholders, and vice versa. Recessions induced by monetary policy hurt unemployed workers and cyclically sensitive industries. But these are secondary, indirect, and diffuse effects, compared to being forced to send a check to the Treasury or receiving one, or compared to the direct

effects of regulatory action and subsidies, as conducted by less independent agencies. While still political to some extent, the limited political tension is suited to the limited independence granted central banks.

The Fed's decision structure is also elaborately constructed by Congress, including the terms of appointment and confirmation of governors, chair, and vice chairs, the nature of regional federal reserve banks, the appointment of their officials, and the potential removal of those officials. These are, of course, in the news now. But the status quo is a delicate and balanced independence, not lifetime appointment and do what you want.

Our questions then go far beyond the terms of office and removal of governors. What should the Fed's mandate be? How should it be enforced? What is the right split between legislation and oversight, and oversight by Congress vs. Administration? What limitations should there be on the Fed's scope of action? How should the Fed be financed? What rules and limits should guide its decision-making processes? Should it continue to encompass monetary policy, financial regulation, bank supervision, and crisis management, and should all of these be equally independent? How far into the non-bank financial system should its crisis support and consequent regulation extend? When, inevitably, central bank activities and fiscal or other policies are in conflict and must coordinate, how is that achieved?

We should not ignore either the elephant in the room. The question of Fed independence and limitations is a mild case of that facing the rest of the government. Most independent departments and agencies have become more powerful and more political over time, and drifted from their original narrow purposes, and more so than the Fed. Many agencies combine law-making (regulation), investigation and prosecution, judgement in administrative courts, and

the imposition of penalties, which some wish to restrict. Should that aggrandized power be subject to more direct control (or “democratic accountability”) by the President, allowing voters a greater chance to more quickly overturn policies they don’t like? Or should we return to a more limited government that has less power to be used or misused by anyone, a precommitment that neither President nor interest groups can use agencies in this way? The courts are leaning to less independence, on constitutional grounds that there are only three branches of government, but also more limitation, for example the “major questions” doctrine. The Fed is somewhat legally special, but the issue does not exist in a vacuum. Some of the considerations apply.

3. Complaints

The Fed *has* expanded and waded into arguably political areas. The Fed bought trillions of government bonds, including monetizing much of the massive 2020 and 2021 deficits. The Fed shortened the maturity structure of federal debt, costing taxpayers hundreds of billions of dollars when interest rates rose. The Fed bought trillions of mortgage-backed securities with the explicit goal of funneling credit to housing and thereby not to other markets. In 2008 and again in 2020, the Fed supported asset prices by direct asset purchases or by lending to intermediaries to finance purchases. In 2020, the Fed lent money directly to state and local governments. The Fed played a central role in the 2008 bailouts.

Central bank expansion, and the need to reconsider its institutional structure, is not unique to the US. For example, the European Central Bank has similarly vastly expanded its activities beyond the narrow set at its founding, now supporting member states’ sovereign debt and implementing large cross-country fiscal transfers.

The Fed has advocated fiscal stimulus, but seldom fiscal restraint. It has dabbled in inequality and “inclusive employment.” It pursued “climate risk to the financial system,” while other regulatory problems festered. (Granted, the Fed did not go down this road as fully as other central banks such as the ECB, and both Chair Powell and Governor Waller spoke courageously against the effort.) The Fed’s regulatory and supervisory arm directs many details of bank operations and assesses penalties for banks that run afoul. Implementing the Community Reinvestment Act, the Fed leans on banks to funnel credit to preferred areas and people. The Fed has cooperated with the debanking of disfavored industries and funded political groups. For example, in 2028, the Fed used its supervisory authority to force banks involved in the robo-signing affair to give money to activist community groups.

The Fed has increased the supply of reserves by trillions, and innovated interest on those reserves. These are very good innovations in my view, but a big change nonetheless that some people decry and that merits examination and hopefully Congressional assent.

In 2020-2021 the Fed presided over inflation that hit more than 10%, which one surely must count as a first-order institutional failure. The Fed had monetized \$3 trillion of Treasury debt, financing the huge deficits of 2020-2021, and unaccountably left interest rates alone for a full year after inflation broke out in February 2021. The Fed has yet to offer any convincing explanation of what went wrong and how it will avoid repeating the mistake.

Complaints about the Fed’s crisis interventions and related financial stability regulation go further back than for monetary policy. The “lender of last resort” to stem financial system crashes is really the foundational role of a central bank. The Fed was founded to be that lender

of last resort after the 1907 crash. It promptly failed in 1933. Since then, we have been on a cycle of expanding intervention matched by expanding moral hazard. The Fed (and FDIC) guarantee depositors and other short-term creditors to stop a run. Then, they try to regulate bank assets to offset the disincentives of a deposit guarantee. Regulation and supervision fail, a new run breaks out, and more liabilities are guaranteed. The 2008 crash, bailouts, and Dodd-Frank regulation were just the latest tour of the cycle. The large interventions of 2020 and the Silicon Valley Bank affair prove that the underlying fragility remains. Now people count on the Fed and FDIC to guarantee all bank deposits, money market funds (two bailouts), to quash price decreases in treasury and corporate bond markets, and provide liquidity in pretty much any market, such as overnight repo in March 2020. Nobody expects a big bank to fail. A perpetual put option, with private gain in good times and sell quickly to the Fed in bad times, is a dangerous practice.

The Silicon Valley Bank case is revealing. The Fed had previously denied segregated accounts and narrow banks such as TNB. Both structures would have provided run-free risk-free accounts 100% backed by reserves, and thus not needing deposit insurance. Critics charge that the Fed was simply stifling competition for the big banks' lucrative deposit base. SVB took large uninsured deposits from these institutional investors and bought long-term treasury securities. If interest rates rose, those banks would swiftly be insolvent. Despite an army of regulators and supervisors deploying hundreds of thousands of pages of regulations, the Fed did not detect and remedy simple interest rate risk combined with large institutional deposits. The bank failed, and deposit insurance was extended ex post to institutional depositors with accounts in the hundreds of millions of dollars. Widespread simple duration risk permeated the banking system under the noses of the Fed's regulators, and interest rate rises wiped out a substantial fraction of bank equity. Yet the Fed is unable to resist pressure from banks to raise

equity requirements and reduce the financial system's reliance on run-prone and illiquidity-prone short-term financing. The next crisis will be larger than the last.

Inflation and financial meltdowns seem like self-evident institutional failures. Perhaps a close analysis will find these to be external events that a perfectly-run Fed could not have forestalled; or that another tweak of the "strategy" and a few hundred more rules will finally end such problems. But the Fed has never had a transparent public accounting of what went wrong, or how it might avoid a repetition. It seems proud of its larger and larger interventions and ready to go again.

Surprise, surprise, the Fed is, in the end, not fundamentally different from the alphabet soup of semi-independent agencies. Once created, they expand steadily, grow staff, budget, and power; they grow cozy with their regulated industries; they start to take on more political roles, influence groups discover their powers, and they accumulate institutional grandeur and power. When trouble looms, they circle the wagons, defend the institution above all else, and never admit mistakes that might weaken the institution's prestige. We should not expect the Fed to violate the laws of public economics.

This is not the fault of individuals. Every Federal Reserve official or employee I have known is a well-intended, smart, honest, hard-working and dedicated public servant. The Fed has historically been one of the most competent and well-run public agencies. There is no story of greed, incompetence, malice, or corruption. The "ethics" complaints are the usual transparent politics, indicating a dysfunctional ethics system that just gums up the works. Throwing "bad people" out and put "good people" in will make no difference.

Moreover, there was no design to the expansion. Events provoked expedients, each of which became permanent. The expansion resulted because neither the Fed nor the government which governs the Fed wished to reform and return to a more limited scope after the fact. Nobody worries about moral hazard in a crisis, the saying goes, but nobody worries about moral hazard after a crisis is over either.

The Fed is not immune to the relentless logic of public economics. Even with the best-intended individuals, independent institutions follow a natural expansionary course until checked. Arguably, the time has come for that check, or at least a reevaluation of the Fed's institutional structure in light of the dramatic changes in the last two decades.

Too much or too little *independence* does not jump out as the central issue in this common litany of complaints. The Fed does not seem to have followed these policies unwillingly, under political pressure. Perhaps a less independent Fed might have followed the Biden Administration's "whole of government" climate and diversity efforts more quickly, though the more independent ECB went much further on climate. Perhaps a less independent Fed might have bent more quickly to Congress' desire to subsidize lending to various constituencies. But these are second-order pressures.

Moreover, Congress or past Administrations do not seem terribly unhappy with the Fed's actions. If anything, individual congresspeople and senators in oversight hearings argue for more discretionary subsidization of credit to various constituencies, and for the Fed to lean more into their political projects. Yes, some of the complaint is that the Fed (and the European Central Bank) acted beyond its mandate. But mandates, like constitutions, are compactly and

generally written, reinterpreted over time, and must be enforced to retain salience. When the Fed reinterprets or expands its mandate, or takes on a new tool, and the Congress does not object, eventually that silence is acquiescence. For instance, Congress and the European Monetary Union mandated “price stability.” The Fed and the ECB interpreted that mandate to mean 2% inflation, on a forward-looking basis, i.e. bygones are bygones and the central banks do not follow a period of above-target inflation with a following period below target, in order to attain the inflation target as an average over time. If Congress meant “price stability,” or wished the Fed to attain 2% as an average over time, it could have objected. In 30 years, it has not done so.

Faced with a more powerful institution, stepping in to classically political areas, one could advocate that the greater power be accepted and the institution become more politically accountable, like other regulatory agencies or even like the Treasury. Advocates of greater “democratic accountability” must, however, face the fact that this Fed would be just as accountable to the next Administration, which might have drastically different plans for it.

The alternative is for Congress (working with the Fed) to restore and enhance limits on the Fed’s mandates and powers and enhance accountability to those guardrails. Congress can refine the mandate and legal limitations, and police then more aggressively. Then the Fed can act with restored independence within those limits. Some of the politically questionable new powers can be transferred to the Treasury or other agencies, including bailouts, some parts of crisis management, term structure management, or ongoing subsidies for particular industries such as buying mortgage-backed securities.

4. Why should monetary policy be independent?

The Fed conducts monetary policy, regulates and supervises banks, and intervenes in crises. When thinking of *Fed* independence, we need to consider the three roles separately. I focus first on monetary policy. What is unique about monetary policy that benefits from greater independence than other policies? What is the question to which independence is the answer, and uniquely for the Fed?

The most common answer is to insulate monetary policy from short-term political pressure, specifically pressure to goose the economy via inflation. President Nixon's strong-arming of Arthur Burns is the classic tale (somewhat mis-told, later).

But that rationale doesn't distinguish monetary policy. Governments are tempted to hand out stimulus checks, tax cuts or exemptions, regulatory favors, loan forgiveness, and other goodies ahead of elections. Yet we do not entrust these policies to independent agencies, and for good reason. Moreover, "political pressure" is also "democratic accountability." If independent central bankers run off with their own policy preferences, become too captured by industry, or become dysfunctional, we want our elected representatives to have the power to correct them.

Economists usually answer, "time consistency," and "precommitment." (Finn Kydland and Edward Prescott won the Economics Nobel Prize in part for their 1977 analysis of this issue.) Inflation is driven by expected future inflation and unemployment or the output gap. If expected future inflation is low, the government will want to trade some additional inflation for less

unemployment today. But people know that the future government will make the same choice, so they expect substantial future inflation, no matter what the government promises today. Then today's inflation-employment tradeoff is worse. The government ends up with high inflation both today and tomorrow, and no greater employment. "Time-inconsistency" means that what the government will wish something different tomorrow (higher inflation) than it wishes today. The government wants to precommit to less inflation than it will desire in the future, when the time comes. Like Odysseus, it wants to tie its hands to the mast.

But other policies have even clearer time-consistency and precommitment problems. The government is always tempted to tax capital "just this once" after investments have been made. If it can, it will. People know that, so they anticipate capital taxes and do not invest. Likewise, once government debt is issued, a "just this once" default is always tempting. But people know that, and don't buy debt in the first place. To borrow, or to encourage private investment, the government must precommit today not to do something that will be very attractive when the time comes. Yet we do not advocate that taxes, spending, and borrowing be determined by powerful independent agencies walled off from Congress and Administration. Precommitment problems are widespread in public policy: housing, business investments, research that yields patents, rent controls, financial bailouts, and more. Yet we do not respond by creating independent institutions with wide authority. Instead, we have other precommitment mechanisms including constitutional protections, legal limits, property rights, and reputations.

Independence alone is a weak precommitment mechanism. Independent central bankers with the government's preferences over inflation vs. unemployment will want to inflate every bit as much as the government. Independence only gives a precommitment if the government

appoints central bankers whose natural preferences are more hawkish than the government's; central bankers who have, from the government's point of view, an irrational or ideological commitment against inflation. To put it mildly, such choices are not evident in appointments or Senate confirmations, especially as I write.

Today's consensus view of monetary policy, focusing on this forward-looking Phillips curve, emphasizes "anchored" expectations of future inflation. Stable expectations allow temporary inflation to offset other shocks without turning into perpetual stagflation. But few at the Fed are willing to say out loud where "anchoring" comes from, other than general expressions of intent. Yes, the Fed is committed to its inflation target, eventually, but just what is the Fed willing to *do* about it? Anchors are easy to talk about in a calm sea. If "anchoring" means anything, it is a precommitment that if 1979 inflation breaks out again, the Fed is willing to repeat the painful recessions of the 1980s, if that's what it takes. That the Fed is unwilling to state the hard threat out loud does not give much confidence that it is either internally precommitted or externally independent enough to make good on the threat. Even then, the Fed quickly backed off its 1980 rate hike when a recession broke out. The Fed was only able to keep interest rates high through a second bruising recession, because it had the political support of the Reagan administration. Independence alone did not suffice. Could the Fed have managed if it had faced a hostile Administration as well as angry farmers in the streets?

Would we even *want* a Fed so independent as to be able, on its own volition, to produce unemployment over 10%, the highest since the Great Depression, in an anti-inflationary quest, over the objections of elected Administration and Congress? Should not such a painful national

adventure require the approval of those representatives, at least in the laws and mandates set up *ex ante* if not in a desire to loosen the ropes when the sirens are signing *ex-post*?

Institutional rules and limitations, indicating the elected branches' long-run desires, and limiting the Fed's *ability* to inflate, are in economic analysis more effective precommitment devices than appointing powerful hawks who don't *want* to inflate and then letting them loose.

Kydland and Prescott's famous article was titled "Rules Rather Than Discretion," after all, not "Appoint an Independent Fed and Let it Loose."

Historically, a law linking the dollar to gold enforced a strong monetary and fiscal precommitment with no central bank at all. The gold standard will not work in the current US economy, but the example makes clear that powerful independent central banks are not the only available precommitment mechanism, and that nostalgia for gold is not entirely misplaced.

Finally, this classic argument relies on the Phillips curve as the central causal mechanism driving inflation, and the central precommitment issue. No Phillips curve, no problem. It views the Fed as able to control inflation, to choose the point on the Phillips curve. The Phillips curve is a mess. The Fed's ability to choose a point on the curve looks fragile. Was 10% inflation really a mistaken Phillips curve choice?

In my view, fiscal precommitments and the temptation of a government to turn to the central bank in a time of uncontrolled deficits will pose a greater challenge going forward than the classic inflation-unemployment tradeoff captured by the Phillips curve.

A government in fiscal trouble is tempted to spend printed money, to inflate away debts, and to interfere in markets (“financial repression”) to hold down interest costs and force people to hold debt. These temptations pose classic time-consistency problems: Precommitting to repay debt ex-post makes the government more able to borrow ex-ante. But ex-post, the government will not wish to repay and only does so to burnish its reputation for future borrowing.

Historically, independent central banks have been instituted far more to precommit against debt and deficit monetization and financial repression than to forswear Phillips curve stimulus, a relatively recent concern. Precommitting to repay debt, not Phillips curve temptation, was a central motivation for the founding of the Bank of England in 1694. In the US in WWII and until 1951 the US government charged the Fed with holding down interest rates, in order to hold down interest costs on government debt. The current “independence” stems from the 1951 Fed-Treasury accord that reduced that fiscal pressure on the Fed, not a Phillips curve stimulus gone wrong. After 1951, financial repression, including legal limits on bank interest rates, regulatory preference for government debt, and capital controls continued to boost demand for US government debt. Even President Nixon’s dealings with Arthur Burns in 1971 and 1972, often repeated in the independence catechism, had an important fiscal foundation. Fiscal problems and inflation had been creeping since 1965 and included the fall of Bretton Woods. They were not an out-of-the-blue Phillips curve stimulus in a healthy economy.

When it works, the precommitment by an independent central bank that it will not allow a fiscal inflation forces the government to better run its fiscal affairs in the first place — to enact the difficult tax, spending, and microeconomic policies that ensure the government can avoid

printing money to cover deficits, or financial repression to force people to hold its money and debt. In the end, the bank forces a government to explicit default and debt restructuring rather than default via inflation, as countries without the printing press must do.

Resisting a fiscal inflation by these means is likely to be much harder than resisting a President's desire for a Phillips-curve election sweetener. The economics is more severe than offsetting Keynesian multiplier fiscal stimulus by monetary restraint. Refusing to monetize debt, allowing interest rates to rise freely as market participants grow worried about repayment, forcing the government to sharp structural tax, spending and economic reforms sufficient to bring back lenders, or to explicit default and restructuring require a strong mandate, fortress-like independence, and steely will.

Imagine the scenario, when the government is borrowing in a war, a severe recession, another pandemic, to finance spending that voters rebel at reforming, or just suppose the bond vigilantes finally arrive and refuse to roll over debt. There is no IMF or Germany large enough to give the US fiscal breathing space. Will the Fed really force explicit default or restructuring, or sharp "austerity?" And all this will happen in the middle of what will surely be called a "financial crisis" of "dysfunctional" markets—and, given the financial system's continued reliance on periodic bailouts and risk-free treasury debt, not without reason. Congress and Administration will be screaming for Fed action.

I cannot imagine independence strong enough that the Fed can resist, of its own volition, in this sort of circumstance. Nor, arguably, should the Fed be *able* to resist on its own. Forcing a debt crisis, sudden sharp benefit cuts, or tax increases are well over the line to "fiscal policy," and "political" not "technocratic."

Recent history agrees. Our government, like many others, reacted to covid and the post-covid year 2021 like a war: spend a lot without asking too many questions, borrow, have the central bank monetize debt and hold interest rates down. Our independent Fed played its part. It didn't want to restrain inflationary policies, so independence was neither useful to that end nor tested. I grant that the Fed and government do not say that inflation was intentional. But they were following coordinated war-finance policies that have created inflation over and over again in the past, and at least not worrying about inflation. Past governments never said inflation was intentional either. Indeed, governments often choose inflation over default or austerity because it's easier to avoid responsibility and instead accuse greed, profiteers, banks, and the other usual suspects.

If the government wants to precommit against fiscal inflation, than, laws and mandates so that the Fed *cannot* allow inflation, and clearly indicating the government's political support for that choice, are much more likely to be successful than pure independence.

The historic gold standard was essentially a commitment against fiscal inflation, and it was a rule. The government promised redemption at a fixed rate. It did not authorize the Fed to independently choose whatever exchange rate for gold it wanted each day. Joining a currency union such as the euro, adopting a currency board, dollarizing, or borrowing in foreign currency are similar ways of making a precommitment against fiscal inflation. Each is a set of rules, not a reliance on independent discretion.

Restrictions on sovereign debt purchases help that precommitment. The Fed is (mostly) required to buy *only* Treasury debt, with the main fear that the bank would otherwise end up

supporting one market over another and one business over another. Previous central banks, including after the German and Austrian hyperinflations of the 1920s were *forbidden* to buy treasury debt, to avoid monetization, with inflationary finance the main fear. Central banks have been required to buy foreign debt, corporate debt, to rediscount private bills (in the original Federal Reserve act) rather than monetize treasury debt. In its original structure, the ECB bought no debt at all and created money by lending to banks against high quality collateral, in part to forestall the temptation against monetizing sovereign debts. Without going to these extremes, it is certainly possible to constrain the Fed against monetizing such immense amounts of government debt, corresponding to fresh deficits, as it did in 2020-2021. If (when) fiscal inflation becomes a concern, all of these are available.

Now, precommitments against fiscal inflation should not necessarily be absolute. In economic theory, rare “state-contingent default” makes bondholders as well as taxpayers and spending beneficiaries pay for a war or crisis.

Inflation, suspension of convertibility, and financial repression have been part of war and crisis finance for centuries. Every US war since and including the revolution has been followed by a spurt of inflation. We would not want to lose WWII on the altar of low inflation, or raise taxes to such an extent as to immiserate the country. One might argue for less inflation than was the case historically. One can argue that covid spending was overdone, and the event was not severe enough to trigger the once in a century state contingent default alarm, but there is an argument for some inflation in a severe enough crisis.

Yet every day is not a crisis, though to politicians and their speech writers it often seems so. Thus, a good joint monetary-fiscal regime precommits that state-contingent default will be rare,

like “just this once” wealth taxes, so that bondholders will lend to the government with only a moderate risk/inflation premium. (In the actual theory of state-contingent default, the occasional defaults should be matched by occasional bondholder windfalls through deflation, further encouraging bondholders to hold debt. This implication is frequently glossed over, to put it mildly.)

The delicate task then, is to construct a precommitment regime that largely avoids fiscal inflation, but allows an exception for genuine national emergencies. Tie hands to the mast, for sure, but not so tightly that one goes down if the ship starts to sink.

That consideration might seem to argue for independent discretion; letting the Fed independently decide when to break the rules. But the choice between inflation vs. sharp tax rises and spending cuts or letting a crisis burn is also intensely political. The elected branches need to own such a decision. Thus, it seems better that the Administration, and better yet Congress, declares an emergency, temporarily suspends legal restraints on inflationary finance, and thereby takes responsibility for the choice of inflation over default or austerity.

The gold standard was subject to occasional devaluation or suspension of convertibility, in just this way, but not by sole decision of the central bank. Pegs can be devalued, currency boards suspended, even the euro can be exited and dollarization reversed. Each has different costs, and thus different precommitment value. But these decisions are not left to independent discretion of central banks.

With a debt-to-GDP ratio not seen since the end of the second world war, a stream of structural deficits looming ahead, and ever greater reliance on rivers of federal largesse in any

crisis or downturn, these fiscal issues are likely to be more important than in the past. At 100% debt to GDP, each one percentage point of real interest rate implies one percent of GDP interest costs, one percent of GDP greater deficit, \$300 billion, real money. We're back to 1951, or maybe 1947. A theme of President Trump's pressure on the Fed has been to reduce interest costs on the debt. Moreover, if inflation breaks out, fiscal pressure on the Fed not to raise rates will add to the usual pressures not to cause a recession via the Phillips curve, and the pressures caused by overleveraged too-big-to-fail banks. To make matters worse, our fiscal problem is a structural deficit, not a large debt carried over from winning a world war in an environment of small primary surpluses. Bond markets are nervous from their recent 15% or so haircut from unexpected inflation. The US capacity to pledge additional repayment in order to borrow in a crisis is in question.

Independent discretion alone is clearly not enough to forestall fiscal inflation. Conceivable rules and better mandates will help, but they are not enough either. Avoiding a fiscal inflation needs the kind of fiscal reform that a government knowing it cannot easily inflate must undertake: Spend more wisely, and restore the fiscal space to borrow instead of monetize when the time comes.

5 Preconditions for independence

The argument for independent monetary policy requires that monetary policy can be primarily technocratic rather than political, largely achieving common goals and not using obvious transfers in the process.

There must be some *separation* between monetary and fiscal policy, and between monetary and regulatory policy. The latter are much more political and unsuited to independence.

Monetary policy must require *discretion*, some human assessment and decision. If monetary policy can be reduced to laws, regulations or rules set down by Congress, it does not need to be independent. A gold standard — \$32 an ounce, period — or a Taylor rule mechanically linking the nominal interest rate to inflation and employment (which John Taylor does not advocate), does not need an independent central bank, any more than the bureau of weights and measures needs to be independent.

But each event is somewhat different, and nobody really knows how monetary policy or financial stability works. Monetary policy requires the sort of dispersed, granular, and soft information that cannot be codified in rules, or is ever accessible to rule-makers.

The need for discretion means that Congress must delegate the operation of monetary policy to some institution. That the institution should have a degree of independence from the Administration follows from the need for precommitment, as above.

I highlight this consideration for sleepy readers. The rest of this essay is an ode to mandates and limitations. Independence is, however, an essential part of the package. The need for discretion in monetary policy is the key reason.

Monetary policy must be *effective* and *competent* at its assigned goals. The independent Fed must have the power to control inflation, employment, financial stability, or other mandated

goals with the limited tools that a technocratic institution can wield. The institution must display a trustworthy competence to deploy that power.

Independence and discretion require *accountability*. In turn, the Fed cannot be accountable for achieving its employment and inflation mandates if it does not have significant power to affect those variables.

The inflation-targeting regimes of the 1990s including New Zealand, Canada, Israel, and Sweden, as well as the European Central Bank, took the principles combining independence with limited mandates one step further than the Fed. These central banks were instructed to ignore employment too, and focus on a single mandate, price stability. In part, this change reflected academic consensus that employment is better stabilized by just stabilizing inflation. The potential benefits of avoiding external “shocks” to employment with a bit of inflation were judged less than the costs of inducing recessions to contain inflation. Once freed from worrying about employment, central banks could be even more independent and more powerful in controlling inflation. Some of these regimes included formal inflation targets, not chosen by the central bank, and accountability for achieving the target as an average over time, not a medium-term forward-looking aspiration. Central banks remained independent and exercised discretion. “We won’t tell you *how* to achieve your inflation target, as that requires expertise, discretion, and information we don’t have. But we will hold you accountable for the result.” And the inflation-targeting reforms included *fiscal* commitments, that governments would spend, tax, and borrow wisely, so as not to face the central bank with the conundrum of validating or fighting fiscal inflation.

All of these preconditions for independence have weakened over time.

When the current doctrine of monetary policy independence developed, debts were small, surpluses regularly followed cyclical deficits to repay debts, and the prospect that the Fed might be called on again to hold down interest costs or monetize debt seemed remote. A generation of formal models simply added a footnote that lump sum taxes would come along to take care of interest costs on the debt or a disinflationary windfall to bondholders. One could think of monetary policy separate from fiscal policy, with inflation-employment precommitments the main concern.

But now, monetary and fiscal policy are deeply intertwined. The tension between interest rates and interest costs on the debt, the possibility of another unfunded fiscal expansion and pressures for monetization as in 2020, the effects of asset purchases on the maturity structure and thus interest rate exposure of the debt, large central bank portfolios of interest-sensitive sovereign debt, and expectations that central banks will jump in quickly to stem any hiccups in sovereign debt markets, all mean that the classic separation of monetary from inevitably political fiscal policy does not hold. And central banks' crisis actions including bailouts, subsidized lending, supporting markets and European sovereigns, all clearly expected to continue and grow from crisis to crisis, clearly cross into fiscal and political territory.

When the current doctrine of independence was developed, the Fed was perceived to have plenty of power with limited tools: setting overnight interest rates and managing bank reserves. Milton Friedman's (or Irving Fishers') famous $MV=PY$, money times velocity equals price level times income, sat at the basis of monetary economics, even if implemented via interest rate targets. The exchange of money M for bonds, without financing deficits, or controlling the internal supply of money through reserve requirements, was thought to have powerful effects

on inflation, indeed to be its only long-term cause. Many academic articles simply posited that the central bank could set inflation P without specifying how. Economists also felt that monetary policy was a central important determinant of cyclical fluctuations in employment.

Today, the Fed's *ability* to control inflation or employment with its limited tools is increasingly in question. We spent ten years with inflation below target, with interest rates effectively stuck at zero. Central banks turned to massive quantitative easing, and negative rates, which had no effect on inflation. In retrospect, the difference between 1.5% and 2% inflation does not seem large, but central banks viewed it as important to assert their credibility. After Covid, inflation surged to 10%. In my reading, this inflation resulted from an unfunded fiscal expansion. But central banks and the policy consensus still seem unable to comprehend this inflation other than as the effect of ill-defined "shocks," by definition movements that we and central banks do not understand, not independently measured quantities. That excuse implies that future "shocks" will lead to similar inflation, which central banks will similarly be unable to control.

Economic theory moved from money to thinking of the Phillips curve as the central causal mechanism driving inflation. Inflation comes a too hot labor market, not the other way around. But the Phillips curve proved fickle, "unstable," a cloud of points sometimes appearing flat, i.e. wide variation in unemployment with no change in inflation as in 2009-2016m and sometimes steeply sloped, with inflation surging despite small changes in unemployment as in the pandemic. Central bankers increasingly focus on the other part of the Phillips curve, that expected inflation drives inflation. But what drives expected inflation, and how do central banks control that? More speeches? Seeing little connection of their actions to inflation, central bankers allude to "long and variable lags."

In complete models, contemporary economic theory offers similarly tenuous control of inflation. Empirical work sees a tenuous relationship between monetary policy shocks and eventual inflation. The plots of the response of prices to monetary policy shocks are small, uncertain, long-delayed, and explain trivial amounts of the variability of inflation and output, overturning Friedman's view that monetary policy mistakes caused most inflation and recession. In currently dominant new-Keynesian economic models, inflation shocks (shocks to the equation with inflation on the left-hand side, sometimes labeled "marginal cost shocks" but not independently measured as such) account for most of the volatility of inflation.

In sum, contemporary theory and empirical understanding does not offer the vision of an effective technocratic control that underlies an agency assigned sole responsibility for inflation.

Oversight and accountability are weak. Fed chairs are routinely grilled by Congress, but effective action on anything like the above list of complaints, all commonplace, has not happened. The Administration is moving more forcefully, but not so far with a great deal of sophistication, hence the concerns over independence that motivates this conference.

6. Financial regulation and crisis management

Crisis intervention poses a classic and clear precommitment problem. A crisis is a systemic run. Once a run has started, creditor bailouts are essentially the only way to stop it. Creditors only stop running to get their money out while they can if they know that the government will stand behind their loans. Yet if the Fed (or Treasury) always quickly bails out creditors, props up prices, and provides liquidity, then people, banks, and financial institutions have little incentive to avoid too much short-term borrowing and issue equity and long-term debt instead,

to contain risk exposures, or to keep some cash or balance sheet capacity around to buy on price dips. Your fire sale is my buying opportunity, unless the Fed front-runs the chance.

The government would like to precommit not to intervene, so that people take adequate care on their own. But after the fact it will intervene to the extent of its power. People know that, so they do not take adequate care, and the government is forced to intervene.

Once again, independence appears a secondary issue for this precommitment problem. People will only believe the Fed (and Treasury) *won't* intervene if those agencies *can't* intervene, and *don't need* to intervene. The Fed will not voluntarily abstain from intervening in a large crisis just to contain some abstract moral hazard next time around, no matter how independent it is. And it's not obvious that once a large crisis has started, not intervening is wise. 1933 was pretty bad.

Moreover, crisis management is necessarily political, involving bailouts, capital "injections," asset purchases designed to raise asset prices, and lending at below-market rates. Letting a crisis run its course is equally political.

So independent crisis-fighting doesn't satisfy the precondition of being plausibly technocratic and a-political. Indeed, the Fed habitually works closely with the Treasury in such cases. The tradition that the Fed lends to a special purpose vehicle in which the Treasury takes credit risk is a useful arrangement. And formal restrictions, which Congress can suspend, are likely to be much more effective precommitments. Much as I disliked the TARP in operation, it shows that Congress can move to change the rules in a crisis.

But here I focus on the extreme cases of systemic crises on the order of 1929-1933 and 2008.

The complaints about the Fed are that even to the Fed every hiccup seems like a crisis.

“Systemic risk” has expanded from systemic runs on short-term debt to mean, apparently, that someone, somewhere, might take a mark-to-market loss on a portfolio, might find they have to roll over short-term financing at unattractive rates, or that specific institutions might not fully pay their creditors. Much more stringent precommitments against intervention make a good deal of sense here. And here the case for Fed independence is strong, as the Administration is much more prone to wishing to bail out individual companies.

One may fruitfully think about an institutional structure in which the Fed and Treasury can precommit to much less frequent intervention, both large and small. The reform needs to combine a simpler and more effective financial regulation so that they don’t *need* to intervene, with formal precommitments not to intervene, with the usual break-glass-in-case-of-emergency exception. The carrot and stick work together. A run-free financial system in which the Fed and Treasury can precommit not to bail out ex-post, based on much more equity and much less short-term debt is entirely possible. But it is unlikely that an independent institution, with the timidity and temptation to capture by the banking system that implies, will institute such a change on its own. Nor, arguably, should it be able to do so.

Going one step further, it is harder to argue that the Fed’s role in regulation and supervision of individual banks and other financial institutions — outside of any objective “systemic” concern — should benefit from much greater independence than the other regulatory agencies, such as SEC, CFTC, OCC, FDIC, and so forth. Yes, it would be nice if financial regulation were more “insulated from political interference,” but it would also be nice if it were more “subject to democratic accountability,” and those are the same thing depending on your party and who is

in power. It's hard to see a precommitment issue. There is a fixed cost issue: Businesses plan to accommodate regulations which should not change too quickly. But the general structure of the administrative procedures act — which itself needs reform, but that's a topic for another day — and the cycle of appointments to independent regulatory bodies accomplishes a good deal of stability and political insulation while allowing broad accountability. A more independent regulator is more likely to be captured by industry. A less independent financial regulator is more likely to be captured by politics. The SEC, for example, leaned into climate regulation much more energetically than the Fed. It will be interesting to see what happens when the Trump administration turns its energies to financial regulators.

Overall, however, I would not hope for any immediate advantages to spring from making the Fed financial regulation and supervision only as independent as the other regulatory agencies, or even as non-independent as the Treasury department. None of those are, currently, exemplars of efficient, transparent, a-political, social-welfare maximizing, technocratic regulation founded on clearly understood market failures.

If one dislikes the Fed's regulatory forays into politics — for example pursuing “climate risk to the financial system” and imposing “climate risk” reporting, de-banking disfavored industries, DEI initiatives, and directing bank lending — that argues to my mind for a narrower and better enforced mandate, not more or less independence. Yes, the Fed went down some of this path in response to political pressure. But it went down the path to some extent of its own accord, and the much more independent ECB went further down the path. Independence insulates the Fed from external politics, but independence also insulates internal Fed politics from external restraint.

7. Costs and benefits of independence

It is common in academic economics to applaud independent central banks, and there is much empirical evidence in their favor. However, much of that evidence comes from the early years of each central bank's independence, not those banks' middle age, when institutional waistlines tend to spread. Independence also usually comes with a package of fiscal and economic reforms. Independence is not randomly assigned to countries. Countries instituted central banks because they wanted to tame inflation. It is hard to tell whether independence or the other reforms mattered most to subsequent inflation and economic growth. Independence comes with limitations, and just which limitations matters as much as the independence.

There are costs of independence, which are rarely considered in the debate. Central banks can be *too* independent. More independent agencies are more prone to ever-widening self-interpreted mandates, ever-larger powers, and the creeping sclerosis of all large organizations mentioned above, already a problem in other agencies.

The failures of the 1933 Fed, leading to a huge bank run, can be viewed as it being too independent, too devoted to defending the gold standard. Milton Friedman and Anna Schwartz's monumental history of monetary policy is in many ways a monumental *critique* of independence, showing how an independent Fed often made terrible decisions.

Over time in the US, the costs and benefits of independence can be debated. Independence is no panacea. Independent central banks can make big mistakes. Other than the famous 1972 Nixon-Burns anecdote, the 1970s Fed is not usually thought of as a lack of independence, but simply that the Fed made policy mistakes. Inflation declined and the "great moderation" broke

out under the independent Fed of the 1980s, but it had the support of the Reagan administration. The list of complaints I started with, beginning with stoking the housing market in the 2000s and the financial crisis of 2008, all emerged under the current independent Fed. It's not obvious that more or less independence would have helped.

Agencies that are more independent of pressure from Administration or Congress are likely to grow cozier with regulated industries. This temptation is especially strong with the Fed, as the banks are, famously, where the money is. Of course, agencies that are less independent are more likely to given in to political pressures.

More independent institutions, anxious most of all to guard their independence, powers, budget, and institutional prestige, are likely to be more timid in reform than institutions that must bend to the reality of electoral change. Witness how long it takes the Fed to change strategies, or its inability to contemplate mild reforms to clearly ill-functioning financial regulations. All administrative agencies are notoriously difficult to contain or reform, even when they are headed by frequently changing political appointees. Fundamental reforms to monetary policy or financial regulation will surely have to come from legislation or energetic executive action.

The European Central Bank is much more independent than the Fed, both by statute and procedures as well as not facing as energetic an executive and legislature. Its larger expansion into fiscal policy and climate policy may lead to a substantial backlash.

An independent Fed, with a clear and limited mandate, has additional benefits. First, it is a handy scapegoat for the Administration: We'd love to lower interest rates and help your

business, but sadly that awful independent Fed won't do it. And we're not allowed to force them to do it. Likewise, a strong limited mandate is useful for the Fed in dealing with Congress. Yes, we would love to print some money and lend it cheaply to businesses in your district, but alas our limited mandate prohibits us from doing that. If you really want it, you need to get all of Congress, plus the President, to lessen our mandate and allow it.

Moreover, an independent, but consequently vulnerable Fed, is more likely to pay attention to legal limitations. The Fed worries *a lot* about the legality of its actions, and if it steps over the line it knows the Administration and Congress can pounce. An Administration, which also controls the Department of Justice, is less attentive to the niceties of, say, just what securities it can buy and from whom.

8. An agenda

So, given the list of complaints, and given the much-changed environment, what is a good set of reforms? How do they balance greater or lesser independence, greater or lesser accountability and oversight, and greater or lesser limitations and mandates?

I phrase the issue as answers and opinions. But that is just a rhetorical device to pose the list of questions that academics, as well as Federal Reserve officials, commentators, legislators, and staffs, along with the interested public should consider.

As above, I favor strengthening Fed mandates, limitations, and accountability to those limitations, rather than more direct political control. These are largely questions for Congress, though with Administration leadership, and whatever supervisory authority the Congress

delegates to the Administration. I find the overall level of independence about right, given the dangers of plausibly too-independent central banks that we see elsewhere in the world.

The mandate needs to be spelled out more explicitly, and also that it means “and nothing else.” Congress, not the Fed, should decide what “price stability” means — inflation, price level, and measured over what period — and hold the Fed accountable for it. The same principle holds, if those mandates remain, for “maximum employment” and “financial stability.” Inflation targeting countries in the 1990s innovated a formal target, and formal accountability for achieving the target as an average over time. This was a useful innovation.

The financial stability mandate should be explicit, and limited. Financial stability means a systemic run on short-term debt. It does not mean that some voter might lose money or some business might suffer bankruptcy reorganization. Specific private institutions are not inherently “systemic.” As above, the Fed and Congress need to undertake a thoroughgoing reform to ensure that bailouts are not needed, and the Fed is not able to make them absent specific authorization.

Exceeding the mandate, as well as achieving the mandate, should be a regular part of Fed accountability.

Part of “and nothing else” is an explicit understanding of where in financial markets Fed responsibility stops. I favor a view that the Fed eschews responsibility for long-term interest rates, credit spreads, stock prices, mortgage rates, and other prices, and does not interfere in those markets. Trying to spot and correct asset market “bubbles,” or “manage the credit cycle” should be beyond the bank’s mandate. The ECB’s view, that controlling long-term rates

and sovereign spreads, opining that market “dysfunction” or “fragmentation” impede “monetary policy transmission,” goes far beyond any solid understanding of that transmission.

The Fed should retain authority over short-term interest rates, achieved by paying interest on reserves, discount window or other lending, or repurchase agreements. (Good proposals exist for changing that basic operating procedure, but that is not for today.)

It is time to rein in the Fed’s asset purchases, outside of crises designated by Congress. Quantitative Easing was an interesting experiment. But a permanent large asset portfolio of long-term treasury and mortgage securities, designed to lower those interest rates, embroils the Fed in fiscal policy and credit allocation to a greater degree than it does any good. If the Fed needs a large balance sheet, it can fund that with short-term treasury debt. The Fed can also, like the ECB, create reserves from thin air via collateralized lending to banks, counting the loan as the corresponding asset.

The Fed and Treasury need a new Accord, on who is in charge of the maturity structure and hence interest-rate risk of Treasury debt. Since this is a fiscal decision, it should be the Treasury. To the extent that the Fed takes duration or credit risk temporarily on its portfolio, it should swap that promptly back to the Treasury.

Other countries, including Switzerland and Japan, have even larger and riskier balance sheets. But they seem to have a political arrangement that allows a central bank to tread much more deeply in fiscal policy. Conversely, a balance sheet that excludes treasury securities, or holds only indexed securities, may be useful someday if fiscal-monetary tension heats up, but not yet.

As I favor abundant reserves, even provided in whatever amounts bank wish via a flat supply curve, I do not favor limitations on the size of the Fed's balance sheet. The Fed's job would be a lot easier if the Treasury would issue fixed-value floating-rate electronically-transferable debt to reduce the demand for the Federal Reserve to buy the Treasury's securities and transform them into that flavor of debt.

I do not favor an interest rate rule, such as the Taylor Rule, as a legislated restraint. It is a useful benchmark for the Fed to report on how it is achieving its mandates. Each time is a bit different, and solid and unchanging knowledge of how monetary policy works is not sufficient to restrict how the Fed should achieve its mandate. The element of judgment and discretion that motivates independence in the first place remains important. Congress should say where we're going, not how to get there.

Financial stability, crisis management, and monetary policy are intertwined. To be credible, the lender of last resort and crisis manager must be able to print money. Only a potentially infinite supply can decisively communicate "*whatever* it takes." And financial regulation and supervision often interact with macroeconomic intervention, including (obviously) in crises, but also impeding or encouraging credit creation. Monetary policy should certainly not be at loggerheads with regulation.

For this reason, I do not favor formal separation of financial regulation and monetary policy. Indeed, I think the formal designation that the Vice Chair for Financial Regulation is somewhat independent is a mistake. But then regulation also must be constrained to that which an

independent institution can provide. The Fed's focus should be systemic risk regulation, narrowly defined.

The temptation to implement monetary policy via financial regulation remains, especially as one suspects that short term interest rates are not that effective. For example, credit-centric views of the Fed's effect on the economy as opposed to sticky-price views tempt the Fed to managing credit directly. It is also attractive to those who applaud the Fed's expansion to general macroeconomic and financial management and welcome every new "tool" that raises the Fed's power. When monetary policy wants more or less stimulus, regulators can tell banks to lend more or less, or adjust capital requirements, as regulators once adjusted reserve requirements. In 1979, the Fed with the Carter Administration imposed credit controls to restrain the economy, generally regarded as a failure. I think overall credit management is a bad idea. But again, this as a central issue in defining the Fed's mandates and limits, and whether there should be tight integration or formal limits separating monetary policy from regulation.

The Dodd-Frank act has failed, and Congress should burn it and start over. At a minimum, Congress can demand that the Fed periodically review its subsidiary regulation under the Dodd-Frank act, to evaluate if regulations are functioning as designed. The Fed could do this on its own, but is unlikely to do so.

Congress can demand greater accountability in general, and a revised mandate offers a framework for doing so. The Fed does not undertake any cost-benefit analyses or risk assessments of its monetary policy, and ignores fiscal impacts of QE.

Monetary and fiscal policy will be faced off in the years ahead. In my view, the Fed needs stronger precommitments against fiscal inflation. Simple independence will not be enough, as we saw in 2020. The will of Congress not to inflate, with the concomitant promise that Congress will sooner or later figure out how to repay debts rather than demand inflation, is a crucial part of the deal. A formal Congressional commitment to repay debt at the price level target, for example by a “debt brake,” would be ideal. It is then up to Congress to declare an emergency, and say “we are willing to risk inflation, but the fiscal situation is dire. We direct the Fed to keep interest costs on the debt low and monetize debt,” as it did in the 1940s.

The reader will note I have little to say about the hot issue of the day: how should FOMC members be appointed, how much authority the President or Congress has to remove them, how many there should be, voting rights on the FOMC, appointment of regional bank presidents, and so forth. I think the structure we have offers a good balance between independence and accountability. The Fed did bend, in my view, to political winds of the last 20 years, but slowly, and, if I force myself to be objective since my politics lean another way, not entirely improperly. If my political preferences were better reflected in office, I would want the Fed to bend back to my views at about the same rate.

The institutional structure of the Fed, from the role of FOMC members to the structure of regional banks, is set up as an information-gathering, and to some extent consensus-building institution. Regional bank presidents spend a lot of time with local businesses, and not just for the free lunch. If one regards the Fed as an elite debating society for setting interest rates on high, one misses much of the genius of its structure.

9. Concluding remarks

The bottom line: Yes, the Fed should remain independent. But refreshed independence must be balanced by a limited mandate, limited tools, and stronger accountability. Only this package will address the Fed's expansion into fiscal and political territory but maintain and enhance the precommitments needed for successful monetary policy and financial regulation.

We must take seriously the problem of a vastly expanded Fed, that has moved into fiscal and political territory. Crying "independence" and defending the status quo will not work forever. If the genie is not put back in the bottle, the Fed will necessarily drift into the orbit of the imperial presidency.

I have largely envisioned reform that requires thoughtful Congressional action. There is a tendency in public discourse to view Congress as dysfunctional, bitterly divided, partisan, and unable to get anything done, and thus to advocate more energetic if questionably legal or constitutional administrative action on one side, or greater untrammelled independence from the Fed.

It is also true that our government has difficulty separating rules, creating an institutional structure that should last another 100 years through trial and tribulation, from scoring political advantage in the moment. On the other hand, Congress did create the Federal Reserve, with an impressive and well-considered institutional structure, and Congress did reform and improve it several times. It is possible to do it again. Congress has passed other significant reforms in past decades.

Our job as academics is to find long-lasting general principles so that when the time comes the library of ideas is not empty. So, though you may say “Congress is dysfunctional,” we should not impatiently rush heedlessly to advocate autocracy—stronger Presidential control—or aristocracy—great power in the hands of an unresponsive elite — in place of the checks and balances of representative democracy.

Literature Appendix

This essay has been reformatted for a journal that does not use extensive citations, so I have moved the discussion of that literature to this online-only appendix. This appendix also provides documentation for several statements in the text.

Book length treatments of Fed independence. include Binder and Spindel (2017), Tucker (2018), and Skinner (2025). On the expansion of European Central Bank activity, see Cochrane, Garicano, and Masuch (2025). Chien, Jiang, Leombroni, and Lustig (2025) document the implicit fiscal transfers in the European monetary union.

Skinner (2021a, 2021b) documents the Fed's push to "climate risk to the financial system."^l Cochrane (2012) documents the Fed's intervention in the robo signing affair, forcing banks to give money to activist community groups.

Kashyap, Stein, Wallen, and Younger (2025) offer a good account of the Fed's intervention in overnight repo markets in March 2020.

Jiang, Matvos, Piskorski, and Seru (2024) give a good account of the Silicon Valley Bank affair, and how widespread simple duration risk was in the highly regulated banking system.

Kydland and Prescott (1977) is, as mentioned, the classic article on precommitment cited in the academic literature. Barro and Gordon (1983) is an influential classic.

Fessenden (2016) gives a good account of the end of Bretton Woods and the fiscal problems underlying early 1970s inflation.

Cochrane (2025) offers an account of the fiscal roots of 2021-2022 inflation.

Sargent (2013) documents the end of hyperinflations, and restrictions against treasury purchases by central banks.

Lucas and Stokey (1983) explain how “state-contingent default” to make bondholders as well as taxpayers and spending beneficiaries pay for a war or crisis can be optimal. Hall and Sargent (2023) show vividly how every US war since and including the revolution has been followed by a spurt of inflation

Friedman and Schwartz (1963) is of course the central work establishing the historic view that the Fed is very powerful, and its mistakes the primary cause of fluctuations.

Cochrane (2024) explains how “contemporary economic theory offers similarly tenuous control of inflation.” Ramey (2016) surveys just how tenuous the empirical work on the effects of monetary policy is.

Admati and Hellwig (2014) are the classic contemporary case for equity financed banking and narrow (100% reserve) deposit-taking. Cochrane (2014) expands on that vision for a run-free financial system.

Tucker (2018) also calls for Congress to define “price stability” and hold the Fed more formally accountable for the result.

Levin and Skinner (2025) note that the Fed’s QE operations proceeded without any “cost-benefit analyses or risk assessments at any stage of the program,” including the cost to taxpayers if interest rates should rise. They advocate strengthened oversight of the mandate, and several reforms to make that easier given the complexity of contemporary monetary policy and financial regulation.

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