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The central bank put its own independence at risk by straying from its narrow statutory mandate.



The Fed Board of Governors meets on June 25. SAUL LOEB/ AFP VIA GETTY IMAGES

The Fed's 'Gain of Function' Monetary Policy

By Scott Bessent

As we saw during the Covid pandemic, lab-created experiments can wreak havoc when they escape their confines. Once released, they can't easily be put back. The "extraordinary" monetary- policy tools unleashed after the 2008 financial crisis have similarly transformed the Federal Reserve's policy regime, with unpredictable consequences.

The Fed's new operating model is effectively a gain-of-function monetary policy experiment. Overuse of nonstandard policies, mission creep and institutional bloat threaten the central bank's independence. The Fed must change course. Its standard tool kit has become too complex to manage, with uncertain theoretical underpinnings. Simple and

measurable tools, aimed at a narrow mandate, are the clearest way to deliver better outcomes and safeguard central-bank independence over time.

One might think that new tools created after 2008 and the centralization of the financial market would have given the Fed greater insight about the economy's direction. At a minimum, all those gained functions should have allowed the Fed to steer the economy more effectively. That didn't happen. In 2009, the Fed forecast that real gross domestic product would accelerate to 4% in 2011. Instead, growth slowed to 1.6%. Cumulatively over that period, the Fed's two-year projections overstated real GDP by more than \$1 trillion. Repeated misses demonstrate that the Fed placed too much faith in its own abilities and in expansionary fiscal policy to spur growth. When the Trump administration shifted toward tax cuts and deregulation, the Fed's forecasts were too pessimistic, underscoring its reliance on flawed models and neglect of supply-side effects.

Successive interventions during and after the financial crisis of 2008 created what amounted to a de facto backstop for asset owners. This harmful cycle concentrated national wealth among those who already owned assets. Within the corporate sector, large firms thrived by locking in cheap debt, while smaller firms reliant on floating-rate loans were squeezed as rates rose. Homeowners saw their property values soar, largely insulated by fixed-rate mortgages. Meanwhile, younger and less affluent households, shut out of ownership and hit hardest by inflation, missed out on appreciation.

By failing to deliver on its inflation mandate, the Fed allowed class and generational disparities to widen. Its pursuit of a wealth effect to stimulate growth backfired. "Unprecedented inequality is clear proof that the wealth effect is all too

effective for the wealthy, but an accelerant to economic hardship for everyone else,” financial analyst Karen Petrou wrote in her book “Engine of Inequality” (2021).

The Fed’s growing footprint has profound implications for independence. By extending its remit into areas traditionally reserved for fiscal authorities, the Fed has blurred the lines between monetary and fiscal policy. The central bank’s balancesheet policies directly influence which sectors receive capital, intervening in what should be the domain of markets and elected officials. Entanglement with Treasury debt management creates the perception that monetary policy is being used to accommodate fiscal needs. Expanded powers have fostered a culture in Washington that relies on the Fed to bail out the government after poor fiscal choices. Instead of accountability, presidents and Congress have expected intervention when their policies falter. This “only game in town” dynamic has created perverse incentives for irresponsibility.

Regulatory overreach compounds the problem. The Dodd-Frank Act dramatically enlarged the Fed’s supervisory footprint, transforming it into the dominant regulator of U.S. finance. Fifteen years on, the results are disappointing. The 2023 failure of Silicon Valley Bank illustrates the dangers of combining supervision and monetary policy. The Fed now regulates, lends to and sets the profitability calculus for the banks it oversees, an unavoidable conflict that blurs accountability and jeopardizes independence. A more coherent framework would restore specialization; empowering the Federal Deposit Insurance Corp. and Office of the Comptroller of the Currency to lead bank supervision, while leaving the Fed to macro surveillance, lender-of-last-resort liquidity and monetary policy.

At the heart of independence lies credibility and political legitimacy. Both have been jeopardized by the Fed’s expansion beyond its mandate. Heavy intervention has produced severe distributional outcomes, undermined credibility and threatened independence. Looking ahead, the Fed must scale back the distortions it causes in the economy. Unconventional policies such as quantitative easing should be used only in true emergencies, in coordination with the rest of the federal government. There must also be an honest, independent, nonpartisan review of the entire institution, including monetary policy, regulation, communications, staffing and research.

The U.S. faces short- and medium-term economic challenges, along with the long-term consequences of a central bank that has placed its own independence in jeopardy. The Fed’s independence comes from public trust. The central bank must recommit to maintaining the confidence of the American people. To safeguard its future and the stability of the U.S. economy, the Fed must re-establish its credibility as an independent institution focused solely on its statutory mandate of maximum employment, stable prices and moderate long-term interest rates.

Mr. Bessent is U.S. Treasury secretary. A longer version of this article appears in the forthcoming issue of the *International Economy* magazine.

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