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POLICY BRIEF

The Mysterium Body Called the Fed: How Discretion Obscures Accountability

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A genuinely transparent and accountable Federal Reserve (Fed) would specify which macroeconomic variables it can control, explain how its policies control the behavior of households and firms, and acknowledge the limits of that control. That level of transparency requires a simple conceptual framework—a model of the transmission process—that allows for debate with the economics profession and provides consistency over time. However, the Fed lacks genuine transparency and accountability because it avoids committing to a clear, rule-based framework. The language of discretion does not substitute for such a policy.

1. The Fed's Language of Discretion

In August 2025 at the Jackson Hole Conference, Federal Open Market Committee (FOMC) Chair Jerome Powell gave a speech that exemplifies the Fed's communication style characterized by the language of discretion. The spirit of Powell's speech was that instability in the private sector arises routinely. At each meeting, the FOMC's job is to evaluate the state of the economy and decide on a balance of risks. That is, the FOMC decides which part of the dual mandate—maximum employment or stable prices—is more at risk and then acts to mitigate that risk. In his speech Powell referred to a number of such episodes of instability confronting the FOMC.[1] Powell said:

> Putting the pieces together [evaluating the state of the economy], what are the implications for monetary policy? In the near term, risks to inflation are tilted to the upside, and risks to employment to the downside—a challenging situation. When our goals are in tension like this, our framework calls for us to balance both sides of our dual mandate. . . . Monetary policy is not on a preset course. FOMC members will make these decisions, based solely on their assessment of the data and its implications for the economic outlook and the balance of risks. We will never deviate from that approach.[2]

As of August 2025, Powell judged that although the risks were roughly balanced, the risk to the employment mandate was slightly more pressing. His statement led financial markets to assume that the FOMC would lower the funds rate at its September meeting.

The spirit of Powell's speech was also that the structure of the economy evolves. About structure he said:

> In approaching this year's review, a key objective has been to make sure that our framework is suitable across a broad range of economic conditions. At the same time, the framework needs to evolve with changes in the structure of the economy and our understanding of those changes. The Great Depression presented different challenges from those of the Great Inflation and the Great Moderation, which in turn are different from the ones we face today.[3]

To counter the episodes of instability and the evolving contemporaneous structure of the economy, Powell said the FOMC needed a full range of tools. In reference to the August 2025 revision to the FOMC's consensus statement, he said: "The revised statement reiterates that the Committee is prepared to use its full range of tools to achieve its maximum-employment and price-stability goals."[4]

Powell also spoke to the fact that the expectations of the public are critical:

> Well-anchored inflation expectations were critical to our success in bringing down inflation without a sharp increase in unemployment. Anchored expectations promote the return of inflation to target when adverse shocks drive inflation higher, and limit the risk of deflation when the economy weakens. Further, they allow monetary policy to support maximum employment in economic downturns without compromising price stability.[5]

Powell's Jackson Hole speech raises questions about the origins of the instability, the long and variable lags in monetary policy, and the need for a consistent rule-based framework to anchor inflation expectations. These questions show the limits of the Fed's discretionary monetary policy.

2. The Limits of Discretionary Monetary Policy

First, in his Jackson Hole speech, Powell fails to address the causes of monetary instability. The first excerpt in section 1 ("Putting the pieces together . . .") shows that Powell implicitly assumes that macroeconomic instability inevitably arises in the private sector. The FOMC goes meeting by meeting, as expressed in the term "data dependent," and observes which shocks are hitting the economy. An analogy would be that monetary policy functions as an iron-dome defense mechanism for the economy: The FOMC watches for incoming missiles (shocks to the economy) and counters them with an offsetting force, that is, movements in the funds rate away from its prevailing value in a way that depends upon which of the two goals of the dual mandate is more affected.

Powell does not consider the alternative: that instability arises from the monetary instability produced by the Fed itself. For example, in the 2008–09 Great Recession, why did disinflation accompany a rise in unemployment? The combination of disinflation and unemployment is a sign of contractionary monetary policy. In the recent Great Inflation of 2021–22, why did a high rate of money growth accompany the inflation? If Powell's characterization is correct that the FOMC makes individual policy actions at each meeting based on the contemporaneous state of the economy, he should explain how the FOMC has solved long and variable lags, an issue raised by economist Milton Friedman.[6] Powell has merely made a statement of good intentions without providing a road map of how individual Fed policy actions work to affect the behavior of the economy.

In the second excerpt, Powell asserts that the FOMC follows the evolving "structure of the economy," but then does not explain where one can find documentation of the FOMC's characterization of that structure—not only in the present but also at various times in the past. Powell's statement that "Our policy rate is now 100 basis points closer to neutral than it was a year ago" must be based on such knowledge.[7]

Finally, in the third excerpt, Powell stresses the importance of "well-anchored inflation expectations." Powell means that lowering the funds rate to counter recession can only stabilize expected inflation if markets trust that the FOMC will raise rates in the future to maintain price stability. In order to forecast the yield curve's response to current policy actions, the FOMC must know how markets view the Fed's future behavior. The FOMC must operate with a reaction function that imposes consistency over time on meeting-by-meeting funds rate changes in response to the arrival of new information on the economy. However, Powell never mentions the need for a rule to impose that consistency. While it is true that the FOMC has an inflation target of 2 percent, nothing in FOMC procedures imposes a discipline on individual FOMC meetings to ensure that achievement over time.

The weaknesses in Powell's account highlight a deeper problem: Discretionary policy leaves the Fed without a coherent explanation of how its decisions transmit to the economy. This lack of consistency undermines both transparency and accountability. A model-based framework is necessary to impose order and credibility on monetary policy.

3. The Need for a Rule-Based Model

Genuine transparency and accountability require that monetary policy be described through a simple conceptual framework, together with an explicit reaction function that imposes consistency across individual policy actions over time—that is a rudimentary model with a rule. The Fed's reflexive rejection of model-based rules is unfortunate. Its message is that it need not employ a predictive model to claim that its policies are stabilizing rather than destabilizing. This stance dismisses the need to learn what constitutes stabilizing policy and to transmit that learning to future policymakers. How, then, should we respond to the Fed's likely claim that it has long managed without being explicit about how its actions transmit to the economy? Such a claim is little more than obfuscation.

Without an explicit framework, the Fed appears little more than the Wizard of Oz, pulling levers behind a curtain of opacity to control the economy. Monetary policy does not control the economy with wartime command-and-control powers. How, then, does the Fed fulfill the dual mandate? Price stability requires that the overall level of dollar prices remain steady, even though firms set prices with the sole aim to adjust relative prices. The Fed cannot simply freeze all dollar prices. Full employment, likewise, requires that firms' hiring and firing collectively keep pace with labor force growth. The Fed must allow markets to make hiring and firing decisions, rather than requiring that each firm employ a number of workers consistent with growth in the working-age population.

Transparency and accountability require that the Fed pursue its objectives within a simple conceptual framework—a model. Yet this requirement is obscured by the Fed's reliance on the language of discretion, which allows any instability to be rationalized as originating in the private sector, with the Fed cast as a corrective force. A model with falsifiable forecasts would compel the Fed to ask whether instability instead originates in its own departure from a stabilizing rule. The Fed's choice of model must, of course, emerge from internal debate. The process would be strengthened by the presence of monetary historians on the research staff— expertise that hardly exists today.

By avoiding any mention of a model, Powell can ignore the stabilizing properties of the price system. He need not discuss an alternative explanation for stability in the economy, namely, that monetary policy is tracking what he calls the "neutral" rate of interest. In doing so, the Fed avoids monetary policy from becoming a source of disturbance in the economy by keeping monetary policy from remaining neither contractionary or inflationary. The Fed is letting the price system manage the economy. Powell refers to the Great Depression, the Great Inflation, and the Great Moderation, but he never suggests that the first two reflected destabilizing monetary policy, or that the last owed its stability to monetary policy remaining neutral.

4. Historical Context

To understand these contentions more fully, it is necessary to review the Fed's history. After the 1951 Treasury–Fed Accord, Fed Chair William McChesney Martin created the modern central bank by assigning it responsibility for controlling aggregate demand. Because Martin viewed price stability as essential, he equated that control with managing aggregate *nominal* demand. Martin termed the policy "leaning against the wind" (LAW).

Under LAW, the FOMC lowers the funds rate when evidence shows that the economy is persistently growing below its potential. Although the Fed does not know the rate of growth of potential real output, using a variety of information it can judge whether the economy's rate of resource utilization is declining persistently (the unemployment rate is increasing persistently). Conversely, the FOMC raises the funds rate when evidence shows the economy is persistently growing above its potential, indicated by persistent increases in the rate of resource utilization (sustained declines in the unemployment rate).

LAW imposes an underlying consistency to monetary policy over time (see my book *The Federal Reserve: A New History* for documentation of episodes of significant departures, all of which are associated with instability in the economy).[8] Given the Fed's emphasis on the importance of discretion, the Fed ignores that consistency in its public communication. It can do so because at individual meetings, judgment is required in evaluating the current and near-term behavior of the economy. Although LAW imposes consistency over time, communication can concentrate on the judgment involved in the forecasts at individual meetings. Monetary policy is not "mechanical" in that the Board staff does not hand the FOMC a formula for the funds rate with suggested values of the right-hand variables.

Moreover, even if the FOMC were to make its LAW procedures explicit, ambiguity would remain. Consider the case in which the economy is growing above potential and its rate of resource utilization is persistently rising. In response, the FOMC initiates a series of increases in the funds rate. One interpretation is that the FOMC is directly controlling the resulting slack, in this case lowering it. The alternative interpretation is that the diminishing slack indicates that the real rate of interest, captured by the funds rate, lies below the neutral rate of interest and needs to rise to equal the neutral rate.

Procedures that cause the funds rate to track the natural rate of interest allow the price system to maintain growth at potential. In this case, persistent changes in the unemployment rate are only an informational variable. The FOMC is not controlling the economy's rate of resource utilization but is allowing the price system to work to stabilize it. In doing so, the Fed is allowing the price system to determine the behavior of real variables (output and employment). The FOMC, then, is not a master of the economic universe but rather a provider of a framework of price stability (a nominal variable) that allows a free-market economy to work to determine real variables.

The consistency imposed by LAW thus highlights a deeper issue: Was the Fed shaping real outcomes, or simply allowing the price system to allocate resources once nominal stability was secured? This question leads directly to the real–nominal debate.

5. The Real–Nominal Debate

The real–nominal distinction lay at the heart of the earlier monetarist–Keynesian debate. Can the FOMC systematically control the real economy so as to achieve a desirable tradeoff between a socially desirable low rate of unemployment and low inflation? Is it necessary to override the unfettered operation of the price system to determine real variables such as unemployment to ensure a satisfactory amount of employment? Alternatively, can the FOMC provide for price stability but then, by necessity, turn over the determination of unemployment to the unfettered operation of the price system? Does price stability allow the price system to maintain the full employment of resources, especially labor?

Transparency and accountability require the FOMC to clarify its position on the implications of the real–nominal distinction. Populists on the left and on the right assume that monetary policy can exercise systematic control over real variables, while they ignore the existence of tradeoffs. If the monetarist view is correct and such control is not possible, then using monetary policy to maintain a low cost of financing government deficits or an arbitrarily low rate of unemployment interferes with the operation of the price system. The result is the equivalent of the macroeconomic version of price fixing. Instability in money creation and, as a consequence, instability in inflation ultimately create instability in the real economy.

6. The Challenge of Communication

The perplexing issue is how to move the Fed beyond "Fedspeak" and toward a model-based conversation. Over time, the Fed has become increasingly defensive of its monopoly over monetary policy. The Fed is especially sensitive to the way in which populist critics exploit evidence of leaks. As a result, the Fed has restricted access to current FOMC deliberations to a small number of individuals at the regional Reserve Banks and the Board. The key individual in this small group is the FOMC chair, because he is charged with designing the character of communication with the public. Communication is limited to discussing forward guidance based on near-term forecasts of the economy. The chair uses the language of discretion to justify the setting of individual funds rate targets because it facilitates a basic consensus within the FOMC. The basic difficulty, then, of engaging in a serious discussion is that FOMC chairs naturally prefer the current character of communication because it secures the dominance of their control over monetary policy.

7. The Urgency of Reform

The need for transparency and accountability is especially urgent today. Defenders of Fed independence claim that the only alternatives are expert-driven policy insulated from politics or hyperinflation of countries such as Turkey, whose central bank is politically controlled. What should one make of that flat assertion? Is a "fortress Fed" really the best defense against populists who want to usurp its apparent master-of-the-economic-universe powers? Or should the Fed instead adopt a simple model that explains which macroeconomic variables it controls, how it exercises that control, and what its limitations are?

About the Author

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Notes

1. Jerome H. Powell, "Monetary Policy and the Fed's Framework Review," remarks, Kansas City Federal Reserve Bank conference, "Labor Markets in Transition: Demographics, Productivity, and Macroeconomic Policy," Jackson Hole, WY, August 22, 2025, 6.
2. Powell, "Monetary Policy and the Fed's Framework Review," 5.
3. Powell, "Monetary Policy and the Fed's Framework Review," 6.
4. Powell, "Monetary Policy and the Fed's Framework Review," 9.
5. Powell, "Monetary Policy and the Fed's Framework Review," 10.
6. Milton Friedman, *A Program for Monetary Stability* (Fordham University Press, 1960).
7. Powell, "Monetary Policy and the Fed's Framework Review," 5.
8. Robert L. Hetzel, *The Federal Reserve: A New History* (University of Chicago Press, 2022).