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POLICY BRIEF

Defending Fed Independence Through Transparency, Accountability, and Rule-Based Monetary Policy

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Today the independence of the Federal Reserve System (Fed) is threatened on two fronts. First, political pressure to suppress interest rates is reemerging. Motivated by a desire to reduce the cost of financing federal deficits, President Trump has called for a return to the pre-1951 Treasury–Federal Reserve Accord regime in which the Treasury capped long-term bond rates. Second, the government's unsustainable deficit, combined with the lack of political will to address it, will inevitably lead to a financial crisis in which bond rates spike and the dollar depreciates. The Fed will likely come under intense pressure to buy long-term debt, and fiscal dominance could replace Fed independence.

In response to the threat of political pressure to suppress interest rates, the Fed's defense of its independence is anemic. That defense has consisted largely of statements by Chairman Powell that the Federal Open Market Committee (FOMC) will decide policy meeting by meeting and use discretion to do the right thing to pursue the dual mandate. As Powell explained: "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."[1] Powell's statement offers no guidance about the implied "approach," apart from doing the "right thing." With regard to the threat of a financial crisis, the Fed lacks a strategy to defend itself against political demands to prevent interest rate increases while Congress debates how to raise taxes and cut expenditures. In both scenarios, the absence of a transparent and systematic monetary policy framework leaves the Federal Reserve poorly equipped to defend its independence against political pressure.

These external threats are compounded by the Federal Reserve System itself. The silence of the regional Reserve Bank presidents is especially inexplicable, given that efforts to limit Fed independence inevitably involve removing the bank presidents as voting members of the FOMC. In the event that some members of the Board of Governors (Board) adopt a pro-administration stance, the regional bank presidents should demonstrate their independence by articulating a clear conceptual framework for monetary policy–one that explains the limits of what monetary policy can systematically control, particularly the real rate of interest on government debt. A historical template for such an approach can be found in the 1970s, when several regional banks broke with the Board and argued that the FOMC should assume responsibility for inflation through a rule enforcing moderate, steady money growth.

This brief contends that greater transparency and accountability are necessary for the Federal Reserve to sustain its independence. A rule-based monetary framework is necessary to anchor inflation expectations and to protect the Fed from political interference during periods of economic and fiscal strain.

Rules, Credibility, and "Leaning Against the Wind"

What kind of conceptual framework could counter the void created by the chairman's reliance on the language of discretion? The first issue that must be addressed is the perennial debate between rules and discretion in monetary policy. Assuming that monetary policy does operate with an underlying consistency (a rule), the second issue is how to communicate it within a conceptual framework that explains what macroeconomic variables the FOMC controls, how it exercises that control, and what are the limitations to that control.

With respect to the first issue, FOMC communication is misleading. Although Fed officials describe monetary policy as discretionary, this portrayal of policy as discretionary is rhetoric that obscures the fact that, because markets are forward looking, the FOMC must impose consistency on its policy over time—even if that consistency is not explicitly communicated—to ensure that the yield curve responds to incoming information in a way that stabilizes the economy.

Since the creation of the modern central bank by William McChesney Martin following the 1951 Treasury–Federal Reserve Accord, the underlying consistency imposed on monetary policy follows what Martin characterized as "leaning against the wind" (LAW). Under the LAW approach, the FOMC raises the federal funds rate to counter unsustainable strength in the economy (persistent increases in the economy's rate of resource utilization with a steadily declining unemployment rate) and lowers it in response to weakness. LAW comes in two versions. One involves preemptive changes in the funds rate to prevent unsustainable economic strength from ending in inflation ("LAW with credibility"). The other involves cyclical inertia in the funds rate in an effort to balance the competing goals of a socially desirable low rate of unemployment and low inflation ("LAW with tradeoffs"). Financial markets likely interpreted the Fed's 2012 framework review (Review of Monetary Policy Strategy, Tools, and Communications) as reflecting the first version and the 2020 review as reflecting the second version.

Why, then, does the FOMC chairman not explain individual funds rate changes in the context of the consistency in policy? A possible explanation is the chairman's genuine preference for discretion in the rules-versus-discretion debate. Advocates of discretion argue that the FOMC can always match the meeting-by-meeting decisions mandated by the rule but then can deviate in emergencies. In the past, such deviations have resulted in undesirable inflation, as in the policy responses to the stock market crash of October 1978, the Asian financial crisis in 1998, and the pandemic in 2020. Milton Friedman made the case against discretion. A rule shapes current public behavior in a desirable way that will not necessarily occur without assurance about how policy will respond in the future to new information on the economy.[2] Michael Woodford presents a more recent exposition.[3]

Historical experience supports the Friedman–Woodford argument. LAW implemented through preemptive funds rate adjustments, which characterized the Volcker–Greenspan era, successfully stabilized resource utilization and kept real output growing in line with potential real output.[4] By making preemptive changes in the funds rate, the FOMC avoided the consequences Friedman critiqued, namely, long and variable lags, and prevented policy from "falling behind the curve." Preemptive changes also reinforced the FOMC's credibility for price stability and disciplined inflationary expectations. In effect, the policy controlled growth in nominal expenditure in a way that maintained price stability. Institutionalizing the rule would involve setting a target for nominal GDP growth aligned with estimates of potential real output growth.

Why Forward Guidance Should Not Replace an Articulated Rule-Based Monetary Policy

The FOMC's current practice of forward guidance has conveyed the message to markets that, in 2026, the only plausible outcome is a steady or lower funds rate. That message comes from the forecasts of inflation and unemployment made by the majority of the FOMC. Although the chairman may emphasize that the FOMC's behavior is data dependent, in reality, markets are treating forward guidance as a commitment. Backing away from that perceived commitment would be disruptive to markets.

In 2026 the economy could grow strongly enough to require a higher funds rate. Viewing monetary policy through the lens of LAW with tradeoffs, the FOMC chairman forecasts a declining inflation rate and a weakening labor market. The FOMC can then presumably lower the funds rate to create a stronger job market without sacrificing its inflation target. If such a policy proves mistaken, the FOMC could still avoid repeating the mistakes of the 1970s provided it treats a return to a 2 percent inflation target as an objective that cannot be compromised. In the event that the labor market strengthens instead of weakens, and the economy grows strongly in 2026, as long as the FOMC then makes preemptive increases in the funds rate, monetary policy will, in fact, be following LAW with credibility. That outcome, however, is far from assured in the absence of an explicit rule. It certainly did not occur with the pandemic monetary policy. Also, in a year with midterm elections, the political pressure to forgo interest rate hikes that would slow the economy will be intense.

A historically unprecedented problem is that the current "no-hiring, no-firing" stasis in the labor market undermines the traditional practice of using labor market indicators like the unemployment rate to judge whether economic growth is unsustainably fast or slow. Raphael Bostic, president of the Atlanta Fed, explained why the labor market is in a state of stasis that is not reflective of relatively strong growth in the larger economy:

> As I see it, there are at least four primary drivers of declining labor demand. One, a number of firms report that they are normalizing staffing from high headcounts amassed in response to elevated demand for goods and services during much of the pandemic period. Two, many business leaders are optimistic that they can use technology to replace jobs that firms would normally need to hire for. Respondents to our surveys report plans to significantly increase investment in technologies like artificial intelligence in 2026. Third, firms have been hesitant to hire amid uncertainty triggered by manifold policy changes this year. Finally, numerous firms are wrestling with dwindling margins squeezed by higher costs and lower consumer demand. As a result, executives at these companies are laser-focused on headcounts.
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> I would categorize the first two of those reasons—normalizing staff sizes and labor-replacing technology—as structural in nature, and thus outside of the purview of monetary policy. Regarding the third driver, I realize there is mixed evidence and opinion on uncertainty shocks. But my strong sense is that volatility in fiscal, trade, and other policies is not something that any modest degree of monetary stimulus can overcome. In other words, I view uncertainty as a structural impediment in the current environment.
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> The signal to take from the last element—shrinking margins—is also not completely clear, since some of the margin squeeze may be due to cyclical factors. But my contacts have consistently reported that much of the margin pressure that firms are facing is specifically due to the high inflation of the past five years, which has raised input costs and reduced consumer demand from low- and middle-income households.[5]

In this situation, the economy's strength is best measured by observing statistics on the macroeconomy. As of late 2025, data showed the economy growing. The Federal Reserve Bank of Dallas Weekly Economic Index registered growth of 2.29 percent on December 6, 2025, and the Lewis–Mertens–Stock Weekly Economic Index recorded the same rate of 2.29 percent on December 13, 2025. Both are high-frequency measures of real GDP growth. Third-quarter real GDP expanded at an annualized rate of 4.3 percent while real final sales to private domestic producers expanded at an annualized rate of 3 percent. The GDP price index for the third quarter rose at a 3.8 percent annualized pace, the highest number since 2022. In terms of the labor market, the weekly initial claims series has fluctuated around 221,500 since January 2022.

Austan Goolsbee, president of the Chicago Fed, expressed similar comments in his dissent over the funds rate voted by the FOMC at its December 2025 meeting:

> Given that inflation has been above our target for four and a half years, further progress on it has been stalled for several months, and almost all the businesspeople and consumers

> we have spoken to in the district lately identify prices as a main concern, I felt the more prudent course would have been to wait for more information. If the labor market were deteriorating rapidly, it would be a different calculation. But most of the data we have show stable economic growth with a labor market only moderately cooling and with measures comparable to those in previous expansions. An environment that can be characterized as "low-hiring/low-firing" is more consistent with businesses dealing with continued uncertainty than it is with a conventional business cycle slowdown.[6]

Taken together, these observations underscore the difficulty of inferring the appropriate stance of monetary policy from labor market indicators alone.

Communication in terms of a rule-based monetary policy requires a simple conceptual framework that explains how monetary policy achieves its objectives.

The FOMC Needs a Simple Conceptual Framework to Explain How It Achieves Its Objectives

FOMC communication is especially opaque with respect to how it achieves its congressionally mandated objectives of stable prices and maximum employment. How does the behavior of the FOMC in setting its policy instruments translate into the desired behavior of the economy? The FOMC does not say. Perhaps, there has been a tacit belief that such silence helps maintain Fed independence by allowing the FOMC to intimate that something terrible could happen if its independence were compromised. However, in today's populist political environment, populist groups on both the left and the right are likely to exaggerate the Fed's powers and attempt to take control of them in pursuit of their own objectives.[7]

The FOMC therefore needs to communicate a simple conceptual framework that clarifies the limits of its control over the behavior of the real economy as opposed to underlying inflation, which it can control. One way to proceed would be to give substantive meaning to the FOMC's use of the term "neutral rate of interest." The FOMC could associate the neutral rate of interest with Friedman's concept of the natural rate of interest. The FOMC's failure to adjust the federal funds rate over time in a way that tracks the natural rate of interest creates inflation without delivering sustained gains in employment, as demonstrated by the experience of the 1970s.

Such a framework, while of the utmost importance in times of political pressure, would represent a sharp break from current FOMC communication. The FOMC is loath to admit its role in creating inflation. As with other adverse outcomes, inflation is portrayed as arising from external forces, with the FOMC cast solely as an inflation fighter rather than an inflation creator. Similarly, the FOMC has been reluctant to explain how excess money creation—over which it exercises control—leads to inflation.

Political and Fiscal Pressures Will Test the Fed

The year 2026 will likely be a perilous one for the Federal Reserve. The economy could grow strongly enough to require an increase in the federal funds rate. A McKinsey survey of corporate CEOs reports a marked improvement in economic sentiment: "In a reversal from earlier in the year, economic sentiment turns more optimistic, with declining focus on trade policy and growing confidence in companies' prospects."[8] As McKinsey reported, in March 2025, 53 percent of respondents expected worse economic conditions over the next six months, while 29 percent expected improvement. By December 2025, those figures had shifted to 32 percent expecting worse conditions and 41 percent expecting better conditions. Also, President Trump will not welcome a higher funds rate that would slow the economy ahead of the midterm elections.

Furthermore, at some point, markets will very likely realize that the federal deficit is unsustainable and that the political will for bipartisan agreement on required spending cuts and tax increases is lacking. Bond rates will rise. Congress, which has the authority to amend the Federal Reserve Act, will likely pressure the Fed to prevent interest rate increases that will lead to the deficit exploding. It will also seek an open-ended period in which to address the crisis of fiscal imbalance. As happened in the "guns and butter" debate of 1967–68, monetary policy could again become expansionary and inflationary if the FOMC keeps interest rates too low.[9] If markets come to believe that fiscal dominance will replace Fed independence, expected inflation will rise, and a debt explosion as the cost of replacing maturing debt rises could bring down the dollar as the foundation of the global financial system.

Traditionally, the chairman's role has been to forge consensus within the FOMC, with that consensus measured by the paucity of dissents. That consensus has rested on the shared assumption that, regardless of individual decisions on the funds rate, the FOMC would ensure 2 percent inflation over time. With a Trump-appointed chair, that role might not be possible. The chair could find himself in the minority. This would raise an immediate risk that markets perceive a divided FOMC unable to raise rates when necessary to maintain the 2 percent inflation target. In a financial crisis, when the Fed is under enormous pressure to monetize government debt, inflationary expectations might no longer remain firmly anchored.

An FOMC consensus signals to markets that the FOMC will impose consistency on policy over time. Essential to that consistency is a commitment to 2 percent inflation, even if some individual policy decisions in retrospect turn out to have been wrong. In situations requiring a policy reversal in the form of an increase in the federal funds rate, it would be important to have a conceptual framework for monetary policy (a model) that makes clear the limits of the FOMC's ability to control, in a systematic way, the behavior of the interest rate when it deviates from the natural rate of interest. Despite reversals in funds rate changes and in forward guidance, a framework implemented through a consistent rule would give markets comfort that monetary policy will overcome internal politics and resist external pressures in order to maintain a stable nominal anchor.

About the Author

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Notes

1. Jerome H. Powell, "Monetary Policy and the Fed's Framework Review," speech at "Labor Markets in Transition: Demographics, Productivity, and Macroeconomic Policy," an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 22, 2025.

2. Milton Friedman, "Should There Be an Independent Monetary Authority?," in *In Search of a Monetary Constitution*, ed. Leland B. Yeager (Harvard University Press, 1962).

3. Michael Woodford, "Central-Bank Communication and Policy Effectiveness," prepared for the Federal Reserve Bank of Kansas City Conference "The Greenspan Era: Lessons for the Future," Jackson Hole, Wyoming, August 25–27, 2025, 399–474.

4. Robert L. Hetzel, *The Federal Reserve System. A New History* (University of Chicago Press, 2022), chapters 19 and 20.

5. Raphael Bostic, "FOMC's Credibility on Inflation Could Be at Stake," Federal Reserve Bank of Atlanta, December 16, 2025.

6. Austan Goolsbee, "Statement from Chicago Fed President Austan Goolsbee on FOMC Dissent," Federal Reserve Bank of Chicago Press Release, December 12, 2025.

7. Robert L. Hetzel, "Making Federal Reserve Monetary Policy Transparent and Accountable," *Journal of Risk and Financial Management*, February 2026.

8. McKinsey & Company, "Economic Conditions Outlook, December 2025, Survey," December 18, 2025.

9. Hetzel, *The Federal Reserve System*, chapter 16.