

## Introduction and Overview: Federal Reserve Wearing So Many Hats is Making its Job Too Difficult

In this report, we focus on Federal Reserve effectiveness in carrying out its “Too Many Mandates” (Table 1). While these mandates may appear to enhance the Fed’s power, over time they have undermined its independence, increased its vulnerability, and, most importantly, reduced its effectiveness.

<b>Fed’s Too Many Mandates</b>			
<b>Fed’s Functions</b>	<b>Formal Reasoning</b>	<b>Conflicts</b>	<b>Effectiveness and Critiques</b>
<b>Monetary Policy with a Dual Mandate</b>	Promoting economic growth by maximizing employment and maintaining price stability	Dual mandate in and of itself is a source of conflicts; maximum employment is not well defined	Fed failed to control inflation in 2021; since then, the Fed has been selective and inconsistent about when it focuses on inflation vs. employment.
<b>Portfolio Management and Security Purchases</b>	Extension of monetary policy, managing more than \$6trn of securities	Security purchases can be used to cover regulatory failure by propping up markets	The Fed has incurred negative operating income exceeding \$200bn dollars and its mark-to-market losses could exceed \$1trn
<b>Regulatory Oversight</b>	Regulation of banks and non-banks to promote financial stability	The Fed may inappropriately use its oversight to support its other functions, such as promoting employment	Federal Reserve did not effectively supervise Silicon Valley Bank, then used its security purchases to cover up its regulatory failure
<b>Economic Research</b>	Federal Reserve carries out research to support its role in monetary policy and regulation	Fed’s research, supervised by political appointees, can be subjective and/or open the Fed to public criticism	Fed’s research has expanded into areas like climate change that are only marginally connected to monetary policy.

*Table 1*

This loss of focus has made it harder for the Fed’s policies to work the way they’re intended to, especially in credit markets. Rather than serving as a steady steward of monetary conditions, the Fed plays an outsized role in market functioning — distorting price signals through interventions in the repo market, emergency lending facilities, and regulatory capital frameworks. These policies, though often well-intentioned, have created dependencies among financial institutions and blurred the line between monetary policy and credit allocation, ultimately undermining the health and efficiency of credit markets.

We are a firm believer in the importance of having an independent, accountable central bank. However, the Federal Reserve has sprawled to a bureaucracy with more than 23,000 employees which has lost billions of dollars trying to “manage” the yield curve.

## **Federal Reserve's Dual Mandate is a Source of Inherent Conflict**

The original sin of the Federal Reserve Act, committed more than a century ago, was assigning the Fed a dual mandate: to maximize employment and maintain price stability. While we view this dual mandate as problematic for several reasons, the tension between the two objectives was not especially severe until the United States abandoned the gold standard in 1971. Under the gold standard, the Fed's ability to pursue loose monetary policy was naturally constrained. Since then, the contradictions and limitations of the dual mandate have become more visible—and the consequences more damaging.

By way of example, over the past 50 years, the Federal Reserve has been at the center of several sizeable controversies related to its conduct of monetary policy, including the high inflation of the late 1970s, the housing bubble of the early 2000s and, more recently, the post-COVID inflation shock of 2021–2022, which still persists.

In practice, the Fed has been using its dual mandate as justification to act inconsistently. For example, in the fall of 2023, the Federal Reserve signaled its readiness to cut interest rates while inflation was high, citing its employment mandate; however, in recent months, the Fed has signaled reluctance to cut interest rates despite lower inflation. Since we believe that the country and the economy would benefit from a more hawkish Fed, we find the inconsistency that emerges from the dual mandate to be troubling or worse, and certainly detrimental to the Fed in the long-term.

There is also the appearance of conflict of interest brought on by the dual mandate. When the Federal Reserve is ideologically aligned with an administration, the Fed focuses more on its employment mandate (e.g. Greenspan and Bush administration in 2000s), while when the Federal Reserve is ideologically hostile to an administration, it will focus more on the fight against inflation.

Moreover, there is limited evidence to support that monetary policy should be the primary engine for maximizing employment. This makes the Federal Reserve's dovishness in recent years less credible. We also highly doubt that monetary policy in and of itself can be used to promote maximum employment, especially given that the definition of "maximum employment" is questionable at best and difficult to measure. The Fed has acknowledged that the maximum employment number could vary over time and that it is dependent on a series of exogenous factors outside the control of the Fed or the purview of monetary policy.

On the other hand, price stability is strictly within control of the Fed and monetary policy. Moreover, price stability can be defined and measured quantitatively—for example, most of the world views 2% inflation as the definition of "price stability." In fact, among major central banks across the globe, the Fed is the only one with a dual mandate. Most of the other central banks have either a single mandate or a hierarchical mandate, with a primary focus on price stability with considerations like employment having secondary importance.

We believe limiting the Fed's primary mandate to price stability, with a well-defined inflation target, would be a better mission statement and one that would eliminate conflicts that undermine Fed effectiveness.

## **Fed as an Investment Manager and Buyer of Securities**

Over the past 17 years, the Fed has significantly expanded its investment activities and has been the largest investor in certain securities. Currently, the Fed's balance

sheet is bigger than that of the largest banks, and the investment risk in its portfolio is comparable to that in the largest hedge funds.

The transition from being a central bank to a *de facto* hedge fund did not happen overnight. The descent down that slippery slope began in November 2008, under the justification that it was necessary to avert a deflationary spiral—therefore aligning with the Federal Reserve’s mandate for price stability. However, since then, the Fed has consistently found new justifications for expanding its balance sheet—first in 2010–2011 to spur economic growth (by then, the deflation threat had passed), and then through Operation Twist in 2011–2012, QE3 in 2013 and 2014 and, finally, the COVID-19 response in 2020 and 2021.

Ambiguity in the Fed’s mandate has acted as the Fed’s enabler to embark on this radical transformation from a central bank into an asset manager. Initially, the rationale for some of the purchases was to fight deflation, but over time they transformed into a framework for financing Federal Government deficit spending whenever Congress’s spending plans aligned with the Federal Reserve’s biases. Most recently, the justification shifted towards the Federal Reserve’s maximum employment mandate, which meant that the Federal Reserve was going to lend money to the Federal government for as long as it could. Therefore, as long as the Fed could find some piece of research that would say government spending will create jobs, additional spending could be justified under the dual mandate.

Essentially, the arbitrary nature of the employment facet of the Fed’s dual mandate allowed its asset purchases to run amuck. Markets, Wall St, and Congress were happy to turn a blind eye as there was limited downside associated with the dual mandate until 2022, when the Federal Reserve started taking operational losses due to the high financing costs associated with its portfolio of holdings approaching \$8trn at the time.

The events of 2022, including runaway inflation, forced the Federal Reserve to start a quantitative tightening program and to incur losses in its portfolio. The large losses in 2023 and 2024 (around \$100bn per year) repositioned the spotlight on the misguided nature of the Fed’s conduct via market intervention. The Fed had always been trigger happy to buy securities, but since then it has been gun-shy about selling them.

The Fed’s investment program is plagued by another major defect that allows it to use various lending and market intervention programs to cover up its failures as a bank regulator. When Silicon Valley Bank (SVB) failed, the Fed essentially offered below market rate loans to the banking sector, which both worsened its operating losses and added fuel to the inflation fire.

The Fed’s accounting for operating losses on its balance sheet remain questionable at best. For years now, while the Fed has been recognizing these operating losses as an income item, it has not accurately reflected them on its balance sheet, instead offsetting the losses by showing that it has a negative liability to the Treasury Department.

Of course, the Treasury Department does not reflect a negative asset on its balance sheet in connection with the Federal Reserve’s operating losses, a practice that distorts the reporting of the GDP and GDI. This strikes us as a flagrant foul, really, even if it goes largely unnoticed.

### **Federal Reserve as a Regulator**

The Federal Reserve’s role as a regulator is a more recent development, significantly expanded under the Dodd-Frank Act. While Federal Reserve personnel have a

tremendous amount of knowledge and expertise when it comes to understanding the financial system, expanded Fed regulatory powers combined with the Fed's penchant for intervention in market operations have created a situation that is fraught with conflict.

For example, we do not believe incompetence was the culprit in the Federal Reserve Bank of San Francisco's failure to supervise SVB. Instead, we believe the Fed's desire to support full employment first in this particular situation made it hesitant to impose existing regulations on SVB. Then, when SVB failed, the Fed rushed into the market with a series of interventions that undermined its credibility and saddled it with additional losses.

One such intervention—the Bank Term Funding Program (BTFP)—exemplifies poor execution in the aftermath of SVB's collapse. The Fed used its emergency lending authority not to stabilize markets, but effectively to cover for its own regulatory failure. Although the program was presented as having no taxpayer cost, it generated substantial operating losses for the Fed, which ultimately translates into losses for the Treasury and, by extension, the taxpayer.

We believe that by any sober reckoning, the Fed's conflicting mandates have made it an ineffective regulator, and its expanded monetary policy powers have made it prone to use its investing and lending program to cover up its regulatory failures.

### **Federal Reserve as Research Think Tank**

The Federal Reserve, through its staff of more than 20,000 employees, produces an abundance of economic research. However, given its conflicting mandate, the integrity and credibility of the Fed's research have come under scrutiny and, indeed, well-earned criticism. In light of the Fed's significant operating losses, it's reasonable to question whether its research expenditures are generating meaningful value—particularly as some topics have ventured into areas that appear more political than economic, such as climate change, racial inequality, the impact of superhero films, and even the role of pets in household financial decision-making. Perhaps ironically, the very Federal Reserve Bank that was responsible for supervision of SVB has published a research paper questioning whether adherence to a 2% inflation target was necessary.

### **A Path Forward for the Fed**

As a roadmap for reforming the Fed, we suggest that its mandate should be simplified to be solely focused on conduct of monetary policy and price stability, with employment being only a secondary consideration. This would allow the Federal Reserve to be more like its global peers and would also position these groups to be more easily judged vis-à-vis their relative performance.

In such a revamp, other functions currently performed by the Federal Reserve could be carried out by agencies independently of monetary policy, reducing the inherent conflicts of interest created by the Fed's sprawling, and often contradictory, mandates.

### **Market Implications and Path Forward**

Recent movements in the US Treasury market and, more generally, the global market for long-term sovereign debt, suggest that it is important for central banks to maintain credibility in their commitment to price stability and fight against inflation. As the world is dealing with an increasing supply of Treasury securities, it is important for households to believe that nominal inflation remains low and is kept at below 2%.



Unfortunately, the conduct of monetary policy by the Fed over the past 17 years has cast doubt on its commitment to price stability. A singular focus on this matter would simplify the benchmark for Fed performance and be a welcome shift for the markets.

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