

THE FUTURE OF THE FED: WE'RE NOT IN KANSAS ANYMORE



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AEA Panel

January 4, 2026

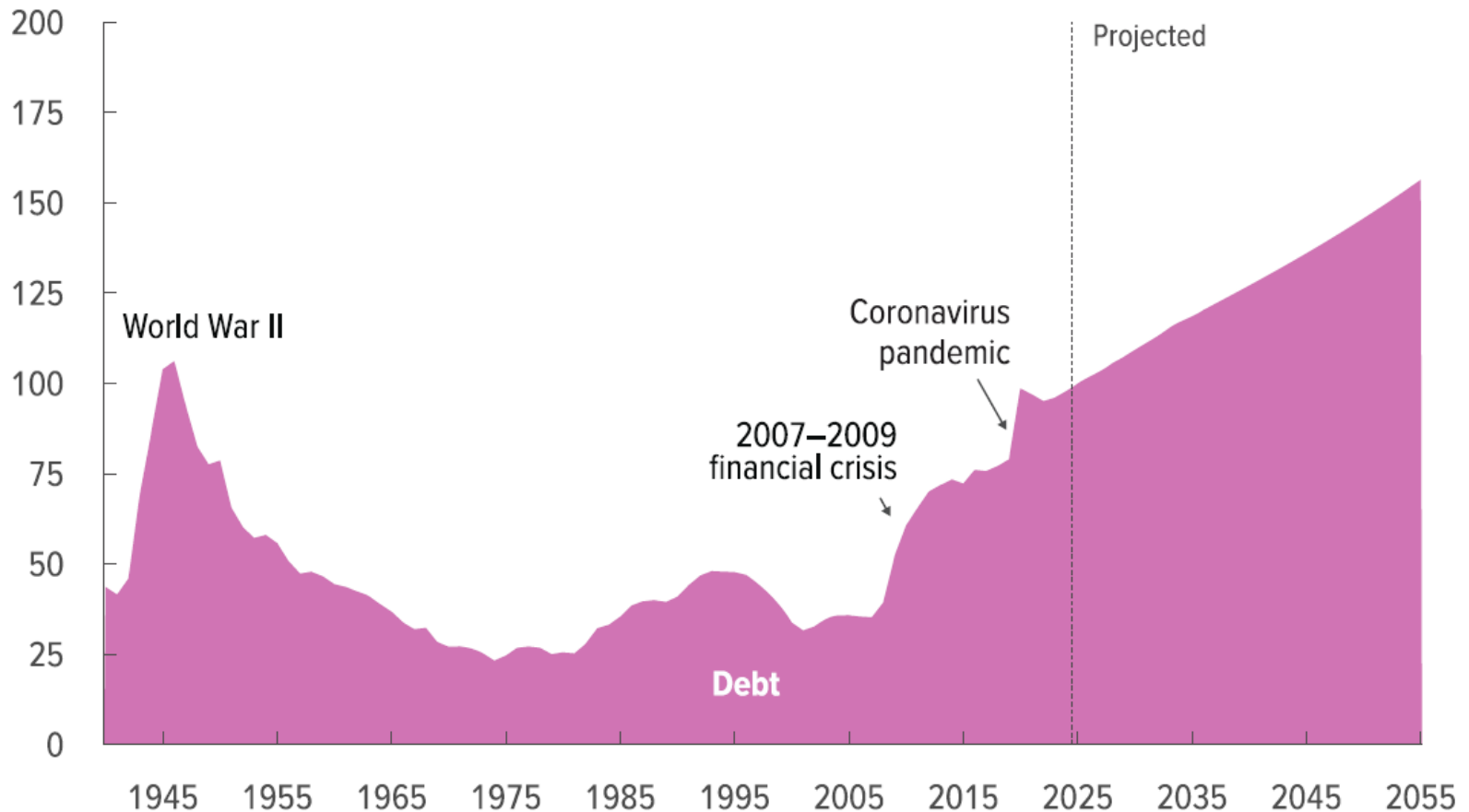
Introduction

- Kansas: Pretty uniform, not very colorful, and you sort of know what life is going to be like.
- Not Kansas: Wild, colorful, and you have no idea what's going to happen.
- I'm going to argue that that's a useful metaphor for the future of the Fed.
- I'll discuss 3 areas in which things may be wild.
- Fitting with my theme that things are going to be very different, the areas are very different from one another.

I. The Looming Fiscal Catastrophe

Federal Debt Held by the Public

Percentage of GDP



Source: CBO.

The Fed's Challenges

- In real time, distinguishing a full-fledged meltdown from a temporary liquidity problem is very hard.
- Example of the U.K. in September 2022.

The Fed's Challenges (continued)

- If fiscal policy stays on an unsustainable path, in the long run the Fed has no good options.
- The combination of rising deficits and the short maturity structure of the debt mean that moderately high inflation would have only modest effects.

Inflation Would Have Only Modest Effects

- Suppose at some point the Fed engineers an immediate, unexpected jump in inflation from 2% to 10%, with the debt's current maturity structure.
- With *no* increase in real rates or risk premiums, after 5 years this would erode only about 15% of the debt.
- If the risk premium rises by 2 percentage points, it would be only about 10%.
- The Fed's only other options are extremely high inflation and standing by as the U.S. defaults.

Source: Author's calculations based on maturity information from [Kozlowski and Jordan-Wood \(2023\)](#).

II. New Technologies: Crypto and AI

- There's been explosive growth in both crypto and AI.

Some Risks from Cryptocurrencies

- Potential runs on stablecoins, and resulting spillovers.
- Potential for spillovers and contagion from price collapse or market breakdowns.
- Harms to individuals from not understanding risks, being taken advantage of in various ways, etc.
- Deeper links with conventional financial markets (e.g., tokenized shares) leading to potential spillovers from crypto to conventional markets.
- Political pressures associated with possible introduction of central bank digital currency.

Some Financial Risks from AI

- Micro: Exponentially better scamming, hacking, insider trading, market manipulation,
- Macro: Rogue AI trading algorithms; extremely correlated trading strategies; hacking at scale;

The Fed's Challenges

- Even with appropriate regulation, the new technologies would create significant challenges.
- The Fed doesn't control regulation, and the current regulatory regime is very lax:
 - Basic disclosure and transparency requirements; limits on margin trading; promises of liquidity; promises of stable values; restrictions on price manipulation and insider trading;

III. Disagreement about What the Fed Should Try to Accomplish—and about Who Should Judge What the Fed Can Accomplish

- For the past 40 years, there's been broad support for the ideas that:
 - The Fed should focus on low and stable inflation, macroeconomic stability, and financial soundness and stability.
 - Judgments about how to best achieve those goals and about what's feasible are best delegated to experts.

3 Examples Where We've Already Seen Pressures to Do Other Things

- Aim for a hot labor market.
- Conduct industrial policy or support specific businesses through credit allocation.
- View low interest rates for the government, households, and businesses as an important end in itself.

The Fed's Challenges

- Why “What can the Fed do?” isn’t really a sensible question in this case.

Conclusion: Two Common Threads in This Analysis

- #1: Declining belief in the value of expertise.
- #2: The challenges are for the most part not addressable through monetary policy, but they can be addressed.
- So, what can be done?
 - The current Fed can show the value of the arrangements we've had for the past 40 years by conducting policy well.
 - ***Much*** more importantly, lots of people need to make the case for addressing the challenges.