Reflections on Monetary Policy and Its Future

Jeb Hensarling, Phil Gramm, and John B. Taylor

This discussion, moderated by John B. Taylor, took place at the Cato Institute's 38th Annual Monetary Conference on November 19, 2020. The transcript has been edited for publication.

Taylor: It's a real honor to have this conversation with Jeb Hensarling and Phil Gramm, two giants of legislation affecting financial and monetary policy. Jeb, of course, was former chairman of the House Financial Services Committee, and Phil chaired the Senate Banking Committee. I have testified before their committees, so for me to have the chance to ask them questions, rather than be subject to their questions, is a treat.

Although this conference will focus on digital currencies, our conversation will be more general, covering the impact of the pandemic on Federal Reserve policy, central bank policy more broadly, and, toward the end, consider the digital dollar.

So, first of all, there's a question about the impact of Covid-19 on policy. Of course, it's had a big impact on actual decisions made at

---

Cato Journal, Vol. 41, No. 2 (Spring/Summer 2021). Copyright © Cato Institute. All rights reserved. DOI:10.36009/CJ.41.2.1.

Jeb Hensarling is former Chairman of the House Financial Services Committee. Phil Gramm is former Chairman of the Senate Banking Committee. John B. Taylor is the Mary and Robert Raymond Professor of Economics at Stanford University and the George P. Shultz Senior Fellow in Economics at the Hoover Institution.

the Fed and, for that matter, on our budget policy. The question is whether those actions are going to change policy in an even bigger way going forward. The Fed's balance sheet has grown to more than $7 trillion. Should the Fed have a more rules-based policy going forward? What about "flexible average inflation targeting?" What are the long-term implications of what's been happening?

Hensarling: Well, if I could, John, just a few acknowledgments. Number one, as an undergraduate at Texas A&M back in the 1970s, I invested $25 of hard-earned money to become a sustaining member of Cato just so I could read their quarterly journals. It was one of the best investments I ever made. In a time when government continues to grow and liberty continues to contract, I cannot think of a more important think tank than Cato. Second, I should say that there was no greater single authority who impacted our policy deliberations when I served as chairman of the House Financial Services Committee than John Taylor. I vividly recall being called by President Trump to ask my opinion on who he should nominate as chairman of the Federal Reserve. I was flattered that the president asked my advice. I recommended Dr. Taylor and spent five minutes going through the reasons. Well, it wasn't the first or last time the president didn't take my advice. Moving on to Senator Gramm, it's so great to be with my friend, mentor, and conservative icon. Many years ago, I signed up for a Money and Banking course at Texas A&M University. Phil Gramm taught me economics then, and he's still teaching me economics.

Now that I've got all these accolades out of my system, John, I'll attempt to answer your questions. I think that, in many cases, the Fed's extraordinary measures today regrettably can become ordinary measures tomorrow. I think a number of these measures were indeed called for, because Covid-19 is probably the greatest single shock to our economic system since the Great Depression, Thus, in the short run, many people may be putting Fed Chairman Jay Powell on a pedestal, but the question is: Will he be taken down in the long run? There are many problematic features of what the Fed has done from a long-run perspective. Most importantly, when taboos are broken, they tend to stay broken; when genies are out of the bottle, they tend to stay out of the bottle.

The Fed's huge balance sheet allows it to engage in credit policy (the *composition* of the balance sheet is by definition credit policy), which inherently auto-resides in fiscal policy—but should auto-reside with Congress. The drift of monetary policy into credit and fiscal policy is a very dangerous precedent. It is going to be very, very challenging for Chairman Powell, at the appropriate time, to shrink the balance sheet and get out of the business of credit policy. In addition, we now know that the Fed is taking on credit risk that it has never taken on before. Consequently, the balance sheet can certainly be injurious to future taxpayers, and it is one more way that the Fed's independence could be compromised.

There is also the problem of "moral hazard" (i.e., taking on risky assets when the costs can be shifted to other parties). Clearly, there was a reason for the Fed to intervene when the federal government, for all intents and purposes, put the economy into an induced coma via the lockdowns in response to Covid-19. However, once you start creating a social safety net under business enterprises, they will take on more risk and exacerbate the trend away from shareholder capitalism toward stakeholder capitalism. Indeed, once the government provides a safety net, ultimately there will be greater political influence upon the free-enterprise system. We're seeing the Fed go from practicing monetary policy, to blurring the lines between monetary and fiscal policy, to totally engaging in fiscal policy. Thus, I think there are many long-run challenges that, if left unaddressed, we will wake up to find our central bankers have become central planners.

Taylor: Jeb, thank you very much. Phil, would you like to comment?

Gramm: Yes. First of all, I guess I should say that I also recommended John Taylor to become Fed chairman. It shows you how much influence Jeb Hensarling and I have!

Well, let's just start with a political Fed. Alan Greenspan was beaten and badgered into saying that, if you've got a budget surplus you'd be better off giving the money back to the taxpayers than spending it. He said it once, after being asked the question repeatedly in testimony before a congressional committee. The *New York Times* condemned his statement as something that could lead to the politicization of the Fed. The Democrat leadership in Congress denounced his statement as well. The current Fed has now undertaken a relentless campaign and in fact become the principal spokesman for greater federal spending. For some six months, the Fed has conducted a daily PR campaign calling on Congress to increase deficit spending. There is no precedent for this action in the history of this country. People talk about politicizing the Fed, but the Fed is now the most political independent entity in American government.

Secondly, when the 2008 financial crisis occurred, the Fed asked for the power to pay interest on excess reserves. I thought when I heard it that they were simply trying to help the banks through a tough period and also that they wanted to pump liquidity into the financial system and assure that banks held the liquidity. But what I didn't understand—and I'm not sure the Fed understood then—is that by paying interest on excess reserves, the Fed turned excess reserves into a financial asset, an income-earning investment for the banks. And so even though the Fed bought some 40 percent of all the government bonds sold during the three quantitative easing programs, it borrowed the money from the banks by paying them interest on excess reserves so the money supply did not expand beyond the needs of trade and there was no inflation. Many economists didn't understand that then; a lot of people don't understand it now.

But now, during the pandemic shutdown, the money supply, M2, has grown by 30 percent. The velocity of money has collapsed. People are holding huge cash balances because interest rates are almost zero and because they are restrained in their ability to spend by the shutdown. However, when things return to normal and interest rates start to rise, the Fed is going to have to do something or the inflation rate is going to start to accelerate.

The federal debt is now 108 percent of GDP, up from less than 80 percent in 2019. The CBO can't foresee a year in the next decade where the national debt won't rise faster than national income, which is a frightening prospect. Moreover, the Fed has a massive balance sheet with the assets it has bought, and it has borrowed the money from commercial banks to pay for those assets. So as astounding as it sounds, the commercial banking system today has loaned more money to the Fed by holding interest earning excess reserves than it has loaned to commercial borrowers.

The Fed has a lot of tools, but it will now have a difficult task in maintaining control of the monetary system it has built over the last 12 years. This is not Alan Greenspan's Fed. And the Fed that we have today and that we're going to have for the foreseeable future is a Fed that is operating unlike any central bank in our history. Unfortunately, every other major central bank in the world has done the same thing. Can there be a happy ending to this policy? I think there can be. Will there be? I think it would require Solomon as head of the Fed and an iron will in Congress to get out of this thing without taking some severe bruises. I don't think we are blessed with either.

Taylor: Well, thank you. You have both made very clear what the problems are that we're facing. I agree. There are so many different aspects of this. The question is: What are we going to do about it? Then there's the issue of whether the Fed should be doing even more with its large balance sheet. Should it be buying particular kinds of securities and making certain kinds of loans? Is this a threat to the Fed's independence? Would legislation come back, reversing what you're looking for, which gives the Fed even more authority and should we be guarding against that? What are the legislative threats that could encourage the Fed to go even further?

Gramm: I'm not worried about Fed independence. The Fed is now one of the most political institutions in American government. For example, the Biden-Sanders unity document talks about the Fed promoting diversity—and the Fed starts talking about promoting diversity. I think the Fed has made itself political, and in the process is not independent of national politics. I am also worried about how the Fed is going to set out a long-term program to wind down its huge balance sheet to get out of the situation where it is borrowing more money from the commercial banking system than the banking system is lending to commercial enterprises. Unwinding this balance sheet will be an extraordinary balancing act.

Also, a very big issue that's got to be decided in the next few weeks is, will the Fed be given the authority to continue to lend money to the private sector after the first of the year. I think that doing that would be a fundamental mistake and extraordinarily dangerous. The last thing on earth we want is for the Fed to be borrowing money from the commercial banks and then lending money to the private sector. It is a formula for industrial policy. It's a formula for inefficiency. The secretary of the Treasury has the unilateral authority to continue this program. I'm sure that many people have encouraged him not to extend the program, including myself. There will be a 20-day period between the time the lending authority expires and President-elect Biden takes office. I think it's very important that this administration lets the new president ask for this authority and lets the new Congress decide whether or not to grant the authority.

Taylor: That's very helpful. Jeb, do you want to comment?

Hensarling: Yes, let me hop in here, John. I think it's certainly foundational to an American economy to have stable money, which is why people believe there should be *monetary policy* independence. Again, I distinguish that independence from *Federal Reserve* independence, because we know the Fed is a huge prudential regulator, lender of last resort, and has other activities beyond monetary policy. So when we talk about monetary policy independence, it begs the question: Independence from what? I believe what Congress originally intended is independence of monetary policy from short-term election manipulation of the money supply and the departure from the goal of stable money.

Now, as Phil pointed out, there are both internal and external pressures on the Fed that are leading it to be less independent. During my tenure in Congress, Congress found a way to go to the Fed to start financing a highway program and the Consumer Financial Protection Bureau. Congress certainly has the power and authority to do this, but it may not be particularly wise to do it. Yet as Phil has pointed out, all of a sudden we now have a Fed opining on climate change and income inequality. Each of these steps leads to a more politicized Fed, which means by definition the Fed and monetary policy are less independent. This politicization has led President-elect Biden and others in the Democratic Party to propose another mandate for the Fed. I think the Federal Reserve needs fewer, not more, mandates.

Given that members of the Fed's Board of Governors are unelected officials, with 14-year terms and their own budget, it is critical to limit their power, not expand it. This leads us into the discussion of a rules-based policy versus discretion. The closer we get to the paradigm of a rules-based monetary system, the better the Fed can shield itself from outside political influences that ultimately could get us away from having the stable money that is foundational to our economic prosperity in America.

Taylor: I certainly agree with the need for a rules-based monetary regime. The problem, of course, is convincing other people who believe the Fed ought to expand its mandate.

Hensarling: Well, John, I think Phil and I both could tell you that there is a never-ending search in Congress for "free money" and "other people's money." Unfortunately, Congress now sees the Fed as that source.

Taylor: Also, internationally, you're hearing the same arguments from the European Central Bank and others.

Gramm: I am not concerned that they're not going to learn a lesson. I'm concerned the lesson is going to be a painful lesson. I am concerned that this thing is going to spin out of their control; and if it does, I think the public will react and the changes will be made. But I think we all would like to see a return to a Fed that is focused on monetary stability and economic growth without the economy having to suffer before the problem obviously requires fixing. So I'm not concerned they're not going to figure out this is a problem. I'm concerned that they're going to figure it out only after the economy is bludgeoned.

Taylor: So let's talk a little bit about what could be done. Of course, the Fed is a creation of Congress in many respects. At Cato's 28th Annual Monetary Conference, I presented a paper, entitled "Legislating a Role for Monetary Policy," which was later published in the *Cato Journal*. I think my article had some appeal: the House passed the Choice Act, which had some of these aspects in it and was along the lines you have indicated, but it never became law. I wonder if those efforts should continue. Is there a possibility that the things that you're suggesting could come from legislation?

Hensarling: Well, it's axiomatic that elections have consequences. So, obviously, we're going to have to wait on the outcomes of elections. My fear is, again, that members of Congress are realizing to what extent the Fed can be used to fund programs that simply bypass the appropriations process and allow members to skip votes that they may not want to cast. So that's my first observation. In Congress, I think, quite often, you have to play a short game and a long game and realize that it may take many Congresses to build the vote for an idea. The Choice Act—and once again, Dr. Taylor, thank you so much for your help and assistance in putting that through—probably represented the most significant positive reform to the Fed in several decades. So the fact that we managed to get it out of committee and off the House floor is notable.

I believe the idea of a more rules-based monetary policy has gained traction. It's been normalized in the House, so it sets a high watermark and makes it easier to return to. Also, I will say this, with my good friend Senator Gramm unfortunately on the line: never underestimate the ability of the Senate to do nothing. Although the Senate failed to take up the Choice Act, there is still, I believe, a lot of desire in the House to move forward. Now, having said that, the Fed—and frankly, no government agency—likes to be told what to do. I vividly remember when Speaker Paul Ryan (who's a dear friend) told me, "You'll never guess who called me! It was Chairman Yellen saying, "Please, please don't allow this bill to come to the floor."

Well, little did she know that the speaker and I think almost identically on the issues in the Choice Act. I thought it was very interesting that the Fed would enter the political fray and lobby. I should make it clear that the Choice Act, as Dr. Taylor well knows, did not mandate that the Fed follow any particular rule. What it did say is, "Tell us what your methodology is." The use of the term "rule" may not have been the best choice of words. What we wanted is greater transparency (e.g., the variables the Fed looks at and the reaction function). It was about communication; it was about transparency; it was about measuring the Fed's approach to other well-accepted methodologies like the Taylor Rule. Having legislation like the Choice Act would increase Fed independence in the realm of monetary policy. Hence, I'm encouraged that we set a high-water mark. We'll have to see where it goes from here. But clearly, these efforts need to continue.

Gramm: Let me say that by the time Jeb's bill passed the House, I was out working for my grandchildren in the private sector, so I wasn't there. When Congress established the Federal Reserve Bank, they gave it extraordinary independence because its goal was very simple, a stable money supply and stable prices. And they required that its members be chosen based on their expertise. What has happened now is that as the Fed moves into areas like climate change, promoting diversity, and even in its new regulatory functions, it is the only significant regulator that doesn't have a bipartisan commission. Its role is changing into a role that has more and more political content—and it's beginning to show in what the Fed is now saying and doing. So I think at some point, there is going to have to be a wholesale restructuring of the Fed to get back to its basic goals.

If things get out of control, then the American people will send the message they want it to be fixed, and, hopefully, it will be fixed in a way that prevents this all from reoccurring. I think one of the things that must be looked at is the Fed's ability to pay interest on reserves. There's no way that tool could be repealed today because the money supply would explode. Nevertheless, establishing a strategy to phase out interest on excess reserves and reduce the size of the Fed's balance sheet is what we need to do. The last thing we want to happen is for the Fed to become a commercial lender, which, I think quite frankly, the pandemic provided a steppingstone toward.

For example, the Biden-Sanders "unity document" calls for the post office to become a commercial lender to consumers and for the

Fed to become a lender to businesses. These recommendations are right out of central planning, and I think they have got to be stopped. I also think that such proposals, once again, show us the direction we're moving in.

Taylor: You both suggested reducing the Fed's balance sheet. But people will ask: Won't that be damaging? Won't it cause pressure in financial markets? Won't there be resistance from Wall Street if that's done quickly?

Gramm: Well, I don't think you could do it quickly, but I think setting out a long-term program to do it would be a very good policy. And look, if you sell the assets at the same time that you lower the rate of interest on excess reserves, you could at least theoretically wind down the balance sheet without disrupting the economy.

Hensarling: If I could add to this, recall there were periods, like the "Great Moderation," when we had very good monetary policy with a fraction of the size of the balance sheet. Also, we know that pre-Covid-19, the Fed was on a path to gradually reduce the size of its balance sheet. That effort ceased with the pandemic. I agree with Phil that we can't abruptly reduce the Fed's balance sheet. Any reduction must be done on an orderly, predictable basis. Otherwise, as Phil noted, we'll end up having a central bank with an unlimited balance sheet engaged in credit policy directed by Congress to serve political interests. That is why I favor gradually decreasing the size of the Fed's balance sheet, which is taking money out of the real economy, lessening disciplinary market forces, and getting us away from any type of independence within monetary policy.

Gramm: John, I'd like to make one more point. The Fed keeps saying that it's going to keep interest rates down for this period of time or that period of time. The Fed has never had less control over interest rates than it has today, never. And the reason is, the banks have these huge excess reserves that the Fed is paying interest on. And if market rates rose and the Fed did not raise the interest rate that it paid on those reserves, the banks would begin to lend them out, and the money supply would explode. So this idea that, "Oh, you can relax because the interest rates are going to be zero from now on so all this debt doesn't matter" is wishful thinking. The problem is that because of the situation the Fed is in, as the largest borrower in the country from the commercial banking system, it has less control over interest rates today than it has ever had.

Taylor: This is very important. But one thing we want to touch on before moving to the next session is digital currencies. So, if either of you would like to comment on that topic before closing this session, please do so.

Gramm: First of all, a currency is valuable as a store of value and a medium of exchange if people will take it in exchange for goods and services. I think digital currencies work as long as people will take them. The federal government makes a lot of money through seigniorage, where it basically gets the benefits from having a monopoly on money creation. Whether Congress is willing to stand by and see private-currency suppliers get that seigniorage is doubtful. Secondly, I think the Fed and the IRS will take action to dramatically reduce the privacy advantage that now comes with using private digital currencies.

Taylor: So, Jeb, would you like to say something about digital currencies?

Hensarling: I think digital currencies are very exciting. I know there are those in Congress, whenever they see a new technology or something that potentially could be disruptive to a government monopoly, who become very disturbed. I think the idea of having a central bank digital currency is worthy of exploration, but certainly not on an exclusive basis. There's the promise of a far more efficient payments system and a far more transparent monetary policy. I know that there are some central banks that are certainly ahead of the Fed in exploring these ideas.

I agree with Phil that the issue of privacy is certainly going to have to be significantly explored. Moreover, with respect to private virtual currencies, the energy expenditure on the mining is another issue that certainly deserves some attention. However, central banks obviously would still have the ability to conduct monetary policy through adjusting short-term interest rates. I think introducing digital currencies could be revolutionary, although I haven't quite concluded this is a good idea. I think it's probably a good idea, and I would certainly encourage policymakers and the Fed to continue their deliberations on this.

Gramm: I think, Jeb, I forgot to mention one thing. If the public shows it really has a demand for these virtual currencies, then there's no doubt the Fed will issue one. And so I think that will become a factor in terms of the value of private alternatives. Now, it may well be that the private sector produces a better currency than the Fed. It's distinctly possible, but you've got all the risks I talked about earlier.

Taylor: Yes. I think at the beginning, Jeb mentioned how emphasizing the private-sector's provision of digital currency is important. We should not try to squeeze private providers out, which was, I think, originally happening. Now it seems to be a more synergistic thing stimulated by other central banks introducing digital currencies.

I think we're now ready to go to the next session. Thanks so much to Phil and Jeb for getting us started, and even thinking a little about digital currencies. There are a lot of questions here that you raised, and I hope some people at the Fed are listening carefully to what you said. So thank you.