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56. Monetary Policy

Congress should

- replace the Federal Reserve's dual mandate with a single stable-spending mandate;
- require the Fed to adopt an explicit rule consistent with fulfilling that mandate;
- reform the Fed's operating framework, so that emergency Fed lending, either to banks or to nonbanks, is unnecessary;
- prohibit the Fed from engaging in direct lending;
- broaden the Government Accountability Office's powers to "audit" the Fed, especially by allowing the agency to investigate violations of the Fed's monetary rule and extraordinary open-market purchases;
- expedite the "normalization" of monetary policy, by prohibiting the Fed from paying banks to hold excess reserves, and by calling for it to shrink its balance sheet; and
- take steps to establish a "level playing field" between the dollar and either actual or potential alternative currencies.

The Federal Reserve (the Fed) is the ultimate source of the nation's most liquid financial assets: bank reserves and circulating currency. As such, its overarching responsibility is to prevent liquidity shortages from causing unemployment or otherwise disrupting economic activity, while avoiding the unwanted inflation and unsustainable booms that result from excessive liquidity creation.

Replace the Dual Mandate with a Single Stable-Spending Mandate

The Fed currently operates under a mandate from Congress, calling for it to pursue both maximum employment and stable prices. This "dual"

mandate can be interpreted so as to be at least roughly consistent with responsible liquidity management. But the dual mandate's ambiguity prevents it from serving as a clear statement of the Fed's mission, as understood by Congress, much less as a device for assuring that the Fed adheres to that mission.

A single mandate to achieve *either* maximum employment *or* stable prices is not a good solution. A simple maximum-employment mandate might be understood as calling on the Fed to create liquidity to boost employment even when doing so would aggravate the boom-bust cycle or generate undesirable inflation, while a price stability mandate might compel it to stabilize prices even when doing so means countering price movements reflecting underlying changes to the overall availability of goods and services rather than excessive or deficient money creation.

Instead, Congress should replace the dual mandate with a single "stable spending" mandate, calling on the Fed to maintain a stable, though steadily rising, level of spending on goods and services or, in other words, a stable dollar value of national income. By creating sufficient reserves and currency to stabilize spending, the Fed would avoid unemployment linked to liquidity shortages, while also avoiding unsustainable booms and general inflation caused not by genuine changes in goods' overall scarcity, but by excessive supplies of money and credit.

Require the Fed to Abide by an Explicit Monetary Rule

Monetary policy works best when monetary authorities have a clear mission and can be trusted to stick to that mission. Otherwise, the public's fear that the authorities will veer from their assigned task can itself add to the challenge of avoiding monetary instability.

Both experience and theory show, however, that mere promises on the part of the authorities are not sufficient to gain the public's confidence. To make such promises credible, authorities must be held accountable for failing to keep them. Accountability can best be achieved by requiring monetary authorities to adopt explicit monetary policy rules, consisting of specific statistics they plan to target and sanctions to be applied if they fail to meet these targets.

Designing a rule appropriate to a stable-spending mandate is, fortunately, very straightforward. The simplest option is for Congress to require that the Federal Reserve commit itself to maintaining a specific growth rate for nominal gross domestic product (GDP)—a popular measure of total spending. The specific rate, as well as other details, might be left to

Fed officials to decide, but most experts would place the desirable growth rate of nominal GDP somewhere in the range of 3 to 5 percent. Meaningful sanctions for violating the rule could consist of financial penalties imposed on members of the Federal Open Market Committee—the committee within the Federal Reserve System that determines the direction of monetary policy. For example, members could be assigned very modest base salaries with bonuses dependent on their success in meeting their targets.

Create a Flexible Open-Market Framework

At present, the Federal Reserve can add to the nation's monetary reserves in two ways. One is by purchasing financial assets in the open market ("open-market purchases"). The other is by directly lending money to banks or (using its emergency lending powers) to nonbanks.

Open-market operations have the advantage of minimizing the Fed's involvement in the *allocation* of credit: the Fed creates a certain amount of new reserves but lets private-market arrangements handle their distribution among different firms. In contrast, when it engages in direct lending, and especially when it targets its loans at specific firms, the Fed becomes more heavily involved in allocating credit, thereby increasing the risk of credit being distributed inefficiently. The Fed's tendency to employ its direct lending powers to support insolvent firms, including those that it considers too big (or "systemically important") to fail, is particularly troublesome.

The ability of open-market operations to get credit where it is most needed is presently limited by the Fed's system of buying only certain kinds of assets, from only a limited number of financial institutions. Normally these limitations are not important; new liquidity, once exchanged for other assets at market prices, tends to make its way to the firms most in need of it. During extreme emergencies, however, normal private-market mechanisms for redistributing liquid reserves among solvent firms can break down. The claim that such a breakdown occurred during the 2008 financial crisis supplied a rationale for unprecedented Fed lending to both banks and nonbanks during that episode.

To make any similar resort to direct lending unnecessary in the future, Congress should make way for "flexible" open-market operations. Specifically, it should require the Fed to (1) conduct open-market purchases, not only with the firms it presently deals with, but also with all financial institutions that presently have access to the Fed's discount window; (2) extend the list of securities it stands ready to purchase to include all securities that are presently accepted as collateral for its discount-window

loans; and (3) replace its traditional auctions with "product mix" auctions, like those now employed by the Bank of England for some of its open-market purchases. Product-mix auctions would allow eligible counterparties with different sorts of eligible collateral on hand to compete more effectively for available Fed credit.

Prohibit Federal Reserve Direct Lending

Because a flexible open-market framework can provide for both the ordinary and the extraordinary liquidity needs of all solvent financial enterprises, having such a framework would make direct Fed lending unnecessary, even during emergencies. Nor should lending to systemically important financial institutions (SIFIs) be an exception: sound SIFIs could take part in the Fed's liquidity auctions; insolvent SIFIs could safely be left to fend for themselves as long as firms that might suffer collateral damage from their failures were themselves able to compete for emergency funds. Congress should therefore prohibit the Fed from engaging in direct lending, including both discount window lending to banks and Section 13(3) lending to nonbanks.

The reforms outlined here would allow a single open-market facility to supply both ordinary and emergency liquidity, making it unnecessary for the Fed to serve as a "lender of last resort." Instead, by attending to its duty to manage the total supply of liquidity in a manner consistent with achieving its stable-spending target, the Fed would automatically meet any emergency liquidity needs. Ordinarily, open-market operations would resemble traditional operations, with purchases largely—if not entirely—confined to Treasury securities, and dealings limited to specialized security dealers. During emergencies, however, other solvent firms facing temporary liquidity shortages would find it worthwhile to compete for new Federal Reserve dollars, using assets not normally employed for the purpose, in an auction specifically designed to ensure an efficient outcome and, especially, to prevent scarce funds from being assigned to undeserving firms.

Audit the Fed's Performance

The Federal Reserve, as an agency empowered by Congress to maintain a liquid financial system, should, like all other government agencies, be accountable to Congress. In practice, that means Congress must, at the very least, be able to monitor the Fed's success in performing its official

duties and report on whether it has employed necessary and proper means in performing them.

The Government Accountability Office (GAO) exists precisely for the purpose of evaluating, on behalf of Congress, the performance of government agencies. As a nonpartisan agency itself, the GAO is able to provide evaluations uninfluenced by partisanship, in response to specific requests. The Fed's current exemption from all GAO inquiries pertaining to its open-market operations and its dealings with foreign central banks thus represents an anomaly—one that Congress ought to correct. If extended to the reforms proposed here, the exemption would amount to a virtual ban on any GAO evaluation of the Fed's performance of its duties, since those duties would be performed exclusively by means of various open-market operations.

Fed officials, among others, complain that, by allowing the GAO to investigate ("audit") Federal Reserve undertakings, Congress would pave the way for unwanted congressional interference with the Fed's setting of monetary policy. Such complaints are misguided for several reasons. First, GAO investigations simply provide information to Congress; they do not alter Congress's ability to challenge Federal Reserve policies. Second, Congress, having empowered the Fed in the first place, has the right, and indeed the duty, to assess the Fed's performance. Admittedly, Congress is capable of interfering unduly with the Fed's conduct of monetary policy. But the best way to avoid such unwanted interference is by clarifying the Fed's mission and responsibilities. By doing so, Congress would rule out politically motivated attempts to creatively "reinterpret" the Fed's responsibilities without having to exempt the Fed from ordinary congressional oversight.

Normalize Monetary Policy

Between 2007 and 2014, the Fed's balance sheet increased fourfold as a result of both unprecedented levels of direct Fed lending and the various rounds of large-scale Fed asset purchases known as "quantitative easing." The expansion was accompanied by an almost equal increase in banks' holdings of excess reserves—that is, reserves exceeding minimum required levels—owing, at least in part, to the Fed's decision to pay interest on bank reserves, including excess reserves, beginning in October 2008.

These and other extraordinary developments have led to major changes in both the Fed's monetary control procedures and its overall involvement in credit allocation. The crisis having now passed, both the Fed's vastly

increased credit "footprint" and the uncertain reliability of its novel monetary control procedures have become objects of great concern.

Fed officials concede the desirability of eventual monetary policy "normalization," meaning a return to precrisis monetary control arrangements and a reduced Fed balance sheet. But so far the Fed has neither taken any substantial steps in the direction of normalization nor committed itself to a definite deadline for doing so. Allowing the Fed to delay normalization indefinitely risks having it continue to play a much larger than desirable part in credit allocation. It also risks having the Fed choose to contain inflation, such as might follow a revival of bank lending, by raising the interest rate on reserves enough to quash the revival, instead of selling assets to reduce its own contribution to the money supply.

To avoid such risks, Congress should compel the Fed to begin regular sales of the securities—especially mortgage-backed securities—it acquired during the crisis. The schedule of minimum sales should ensure that the Fed can rid itself entirely of the less liquid securities in its portfolio within seven years. To avoid having such sales undermine monetary control, the Fed must be allowed to offset them, when necessary, by purchasing ordinary (short-term) Treasury securities.

Finally, to complete as well as expedite the normalization process, Congress should stipulate the phase-out of both interest payments on banks' excess reserves and the Fed's "overnight reverse-repo" facility, which serves as a means for making similar payments to various other financial institutions, including money market mutual funds. To the extent that it contributes to a revival of bank lending and investment, the phase-out of interest on excess reserves would allow the Fed to dispose of mortgage-backed securities more rapidly, or at least to resort to offsetting Treasury security purchases less frequently.

Establish a Level Currency Playing Field

Congress could further encourage the Fed to manage the dollar responsibly by establishing a level playing field between the U.S. dollar and its potential rivals. This move would also make it easier for U.S. citizens to use alternative means of payment when doing so makes them better off.

To level the field on which the dollar competes with other potential means of payment, Congress should repeal 31 U.S. Code § 5103, which makes Federal Reserve notes and Treasury coins "legal tender for all debts, public charges, taxes, and dues." Specific performance of contracted obligations should instead be the sole remedy for breach-of-debt contracts,

no matter what means of payment they specify. Congress should also prohibit any taxation of private exchange media, whether physical or digital, that would make using such media more costly than using dollar-based monies. Among other things, that would mean exempting alternative exchange media from either sales or capital gains taxes.

Finally, Congress should repeal those parts of U.S. Code, Title 18, that make it illegal to make, possess, or circulate private metal coins or tokens that resemble coins. Although Congress has good reason to prohibit the actual counterfeiting of official coins, such counterfeiting is separately and adequately dealt with by 18 U.S. Code § 485.

Suggested Readings

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