Lessons for the Fed from the Pandemic

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The Covid-19 pandemic greatly increased the scope and power of the Federal Reserve. The Fed created a number of new emergency lending facilities, which allowed it to make off-balance sheet loans and buy the debt of corporations and municipalities through special purpose vehicles backstopped by the Treasury under the CARES Act. Meanwhile, the Fed's large-scale asset purchase program, known as quantitative easing (QE), was put on steroids after the pandemic struck in March 2020. The Fed has been purchasing longer-term Treasuries and mortgage-backed securities amounting to $120 billion per month, pushing the size of its balance sheet to an astonishing $7 trillion.

Of course, the pandemic and lockdowns, which put the economy in a downward spiral, justified pumping liquidity into the financial system. But the shift toward allocating credit and the drift into fiscal policy have put the Fed's independence and credibility at risk. Indeed, those actions have set a precedent for the future, making it difficult for the Fed to normalize monetary policy and adhere to its primary function of providing sound money and a stable growth of nominal income.

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This conference's focus is on digital currency. In my remarks today, I will paint with a broader brush and briefly discuss the lessons I think the Fed can learn from the pandemic, including why it is important to leave entrepreneurs free to experiment with digital currencies and why any credible monetary system ultimately needs to be based on a genuine rule of law. I shall begin by arguing that while Covid-19 has been costly, both in terms of human and economic losses, it has provided for deregulation and innovation that will benefit society.

The Pandemic's Costs and Opportunities

The human costs of the pandemic have been high, with more than 550,000 deaths in the United States alone, a huge disruption to family life and schooling, and a sharp rise in uncertainty. Economic costs are evident in high unemployment, the closing of tens of thousands of small businesses, the loss of human capital in terms of lost or delayed schooling, and the major disruption to the travel industry. While the growth of output and income will resume, the level of real income per capita will take some time to recover. In part, because the massive debt incurred by the federal government is not a free lunch.

In 2020, the federal government borrowed more than $4 trillion compared to about $1 trillion in 2019. More importantly, the majority of the new debt is being financed by the Fed (see Cochrane 2020). With the tap of a few computer keys, the central bank is creating new base money to buy government debt. Although inflation expectations are still relatively low, continued monetization of government debt could generate higher inflation—especially since it is a key aim of Fed policy to push the average level of money prices upward.

Despite the serious costs of the pandemic, the responses to it have reduced costly government regulations and speeded up the development of vaccines via the private sector and encouraged new technologies. These developments provide important lessons that relate directly to Fed policy, especially with regard to digital currencies.

Lesson 1: The Value of Reducing Onerous Regulations

If reducing government regulations can have such undeniable success, shouldn't one ask where else this lesson can be applied? The Fed is certainly a contender and the application is quite clear.

Let markets operate, let people operate, and you'll get much better results, much faster than government alternatives.

Earlier in the conference, Tobias Adrian noted this idea when he argued, "The private sector is better at innovating. So whatever the central bank is going to do, it's going to be outdated at some point." Central banks across the world, not just the Fed, would be wise to heed these words if they wish to enter the digital currency space. Rather than restrict private firms to a corner of an unknown frontier, the government should be praising entrepreneurs for paving the way forward.

This is a lesson that is as old as money itself. Private entrepreneurs have offered countless solutions throughout the history of money. It would be a great mistake not to learn from the past and present experience when facing the current challenge of digital currency. Just as reducing regulatory barriers has aided the pandemic response, it can also aid progress and innovation in the digital currency space.

Lesson 2: The Benefits of Embracing Technological Change

Another important lesson for the Fed from the pandemic is how technological change has provided new opportunities for consumers and businesses to adjust to the pandemic. The shift to online commerce and remote learning has accelerated during Covid-19. Zooming, for example, has become commonplace in a short time span. It is likely that nongovernment digital currencies will increase in popularity as the technology becomes more accessible and the companies behind each currency become more competitive.

As private-sector options for digital currencies increase, there will be further pressure on the Fed to issue its own digital currency. Congress should welcome competitive currencies while ensuring that the Fed maintains the dollar's long-run purchasing power.

The Fed may have a significant advantage in introducing a digital dollar. However, that advance may lessen as technological advances decrease the cost of experimenting with nongovernment digital currencies. An apt example of this can be seen in the current state of bitcoin. At one time, it took highly specialized knowledge to purchase a coin and then know how to use it. Today, anyone can download an app to their phone in order to buy and sell bitcoin—as easily as making a purchase off of Amazon. Even though digital currencies are still very young, it would be a mistake to overlook this technological transformation.

Lesson 3: The Need for Clear, Enforceable Rules

In addition to the value of reducing onerous regulations and the benefits of technological progress, there is a third lesson for the Fed: monetary policy would be more certain under a rules-based regime. The monetary measures introduced during the pandemic have given the Fed wide discretion to allocate credit and engage in off-balance sheet ("backdoor") lending. This shift in focus—from pure monetary policy to credit/fiscal policy—risks making the central bank a piggy bank for Congress to implement programs that may not have sufficient votes to pass the legislative process. George Selgin (2020a) has called this process "fiscal QE."

To avoid the risks of further politicizing the Fed, Congress needs to seriously examine the case for clear, enforceable rules—rather than wide discretion—in the conduct of monetary policy (see Dorn 2020 and Selgin 2020b). Under a rules-based monetary regime, market participants would no longer need to guess what the Fed can and cannot do. And the Fed itself would be constrained such that it too would have a clear understanding of the tools it can and cannot use. Without such a clear distinction, there is a risk that one will blur the line between monetary and fiscal policy

Conclusion

The private sector should be commended for the speed at which a vaccine was developed, and the government should be commended for pulling down the restrictions that would have blocked that from happening. However, it should not take a global pandemic to recognize the value of reducing undue government regulations and embracing technological change. More so, it should not take a global pandemic to recognize why there is a need for clear, enforceable rules.

If the Fed does not reverse the drift into fiscal space and the allocation of credit, it will become more politicized and less independent. The Fed was never meant to have unlimited powers or wide discretion. It is a creation of Congress and needs to be subject to the rule of law. There must be a bright line between monetary and fiscal policy. The aim should be to establish a sound monetary policy to provide long-run price stability and let markets be free to provide alternatives to government fiat money.

The pandemic has taught us that removing barriers to experimentation and innovation speeds up the discovery process, whether for vaccines or new ways of doing business. Private digital currencies are yet one more example of how markets find ways to lower costs and provide a wider range of choices open to individuals.

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