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What Should the Fed (and Congress) Do Now?

BY NORBERT J. MICHEL

As COVID-19 spread across the globe, governments issued stay-at-home orders and shuttered their economies. In the United States, between the fourth quarter of 2019 and the second quarter of 2020, nominal gross domestic product (NGDP) fell from $21.7 trillion to $19.5 trillion. This 10 percent decline, which surpasses anything in the historical record, was followed by a decline in the overall price level.

Then, unexpectedly, the economy roared back to life. Between the second quarter of 2020 and the fourth quarter of 2020, the NGDP increased by 10.27 percent, the largest two-quarter increase in the historical record. This revival was followed by another 8 percent increase in the NGDP through the third quarter of 2021. However, this rapid resurgence in demand exacerbated the major supply problems that the pandemic and the government shutdowns had caused. Partly because of these large swings in supply and demand, inflation (a rise in the overall price level) began a steep upward trend, one that has not yet fully dissipated and has caused enormous dissatisfaction with government policy.

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Inflation, as measured by the consumer price index (CPI), has been on a mostly upward trend since May 2020, increasing at an above-normal rate through much of 2022. The year-over-year change in the CPI has been near a 40-year high in practically every monthly release for the past 12 months. The natural tendency is to associate high inflation with monetary policy, faulting the Federal Reserve for "printing too much money," but the current bout of rising inflation is not entirely the Fed's fault.

For starters, monetary policy should not be viewed as wholly independent of fiscal policy. The Fed serves as a fiscal agent of the United States. Even though the Fed is legally independent, it is, in practice, always under political pressure to accommodate the government's fiscal policies. In large part owing

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Sen. Patrick Toomey (R-PA) speaks at a Cato policy forum in June on the case for international free trade and the future of trade liberalization.

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to accommodating a recent federal spending spree, an active choice by Fed officials, the Fed now holds almost 30 percent of the outstanding federal debt held by the public, up from 22 percent in 2014.

In March 2022, Congress passed a $1.5 trillion spending bill, the last in a series of spending packages (mostly, but not exclusively, under the guise of emergency COVID-19 relief spending) that totaled $7.5 trillion. This prolific government spending increased Americans' disposable income well above the average growth rate, and the resulting increase in consumer demand worsened the many supply-side problems caused by the pandemic and the government-imposed shutdowns. Thus, the recent inflation can be attributed to one of the largest spending sprees in the nation's history and the Fed's decision to avoid offsetting those fiscal policies, as well as government-induced supply problems.

The supply problems have been particularly controversial and have exposed major flaws with modern central banking. For instance, although people commonly focus on how the Fed "sets interest rates," the Fed does not have precise control of interest rates. In fact, it does not have precise control over inflation or unemployment, even though it tries to "manage" the overall economy on the basis of these variables. All monetary policy can do is influence the economy by either loosening or tightening the overall flow of credit. In other words, the Fed can use monetary policy to ease or restrict the overall flow of credit in the economy, a rather blunt instrument. It does so with specific macroeconomic goals in mind, but monetary policy does not give the Fed precise control of overall lending, the overall economy, or specific macro variables such as interest rates and inflation.

ALWAYS AND EVERYWHERE?

Even worse for the current inflation episode, monetary policy is particularly impotent when it comes to addressing supply-side problems. This statement may seem surprising given Milton Friedman's famous line that inflation "is always and everywhere a monetary phenomenon," but there is more to that quote. In full, Friedman said that inflation "is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." It is often ignored, but nonmonetary factors can drastically impair output. That is, events that have nothing to do with monetary policy can hamper businesses' ability to produce goods and services at the rate they had previously planned.

> "Nonmonetary factors can drastically impair output."

A major hurricane in the Gulf of Mexico, for example, could force multiple oil rigs and refineries to shut down production for an extended period. The resulting decrease in the supply of gasoline would likely increase prices at the pump and, if severe enough, even push the overall price level well above the Fed's target because energy prices are such a large component of the overall price level. The COVID-19-related disruptions undeniably had this type of effect on oil and gas prices, even though the events had nothing to do with monetary policy.

Nonetheless, tightening the overall flow of credit—exactly what any inflation-targeting central bank would do to lower inflation—would do nothing to help in this scenario because the inflation is caused by a supply shock. Specifically, monetary tightening would make it more difficult for everyone to obtain credit but would do nothing to increase the production of oil and gas. People would be left with higher gas prices and less available credit in general. Naturally, even if they push up the overall price level, the higher gas prices serve the important function of (all else constant) raising the resources devoted to producing more, thus clearing the scarcity of fuel. So not only is monetary policy counterproductive in this supply-shock scenario, but a central bank targeting the price level also would be attempting to stamp out the very conditions that would otherwise help clear the scarcity of fuel.

Another major problem with conducting monetary policy by targeting the price level is that it is very difficult to tell, in real time, whether price-level changes are occurring because of supply constraints—such as those described above—or increases in consumer demand. Thus, the current bout of inflation, driven by both supply and demand factors, also serves as a testament to why a central bank should not try to actively manage the price level. In fact, given the weak connection between monetary policy and multiple macroeconomic variables, such as the unemployment rate, the current economic situation provides a stark example of why central banks should not be tasked with managing the economy at all.

THE RECORD OF THE FED

Unsurprisingly, the evidence shows that the Fed has not been very good at "managing" the overall economy. For instance, the average CPI inflation rate was 3.56 percent from 1948 to 1978, and 3.74 percent from 1979 (when the Fed first had a formal price stability mandate) to 2013, well above the Fed's favored 2 percent target. On the Fed's watch, deflation (a general decline in prices) has all but disappeared, even though deflation can be the byproduct of a healthy, growing economy—one that would otherwise allow people to obtain goods and services more easily.

Perhaps more important, when the entire Federal Reserve period is compared with the

full pre-Fed period, the frequency of recessions has not decreased. Although recessions were more frequent in the pre–World War I era than in the post–World War II period, this comparison omits roughly 30 years that included the Great Depression. Still, even when the interwar period is excluded, updated data suggest that the average length of recessions, as well as the average time to recover from recessions, has been slightly *longer* in the post–World War II era than in the pre-Fed era.

REFORMING THE MONETARY SYSTEM

Going forward, the key policy question is how to reform the U.S. monetary system so that the Fed is no longer tasked with trying to manage the economy while also refraining from worsening the monetary system and the broader economy. Given the U.S. dollar's global acceptance and the Fed's outsized role in the economy, this feat is no easy task. The Fed has monopoly control over the monetary base of U.S. dollars, a fiat currency that has effectively become the base money for many developed nations and is used to settle most major international trade flows.

Congress has given the Fed too many responsibilities. It has an ill-defined congressional mandate to maintain price stability and maximum employment and an even less clearly defined mandate to guard against financial instability. None of these mandates are ideal, but they entangle the Fed in virtually all aspects of financial markets and economic activity. The Fed has regulatory authority over some of the world's largest financial institutions, and it has shifted to an operating system designed to easily accommodate the massive fiscal expenditures necessary for projects such as the Green New Deal or an infrastructure bank. The Fed's reach and importance in the monetary system are so extensive that simply getting rid of the Fed without any viable monetary alternative in place is both economically and politically impractical.

> “Congress has given the Fed too many responsibilities.”

Thus, shrinking the Fed's footprint, while politically difficult, is a more practical approach, one that is much less likely to worsen the monetary system and the overall economy. To shrink the Fed's footprint, Congress should relieve the Fed of its regulatory role and force it to return to the operating framework it used before the 2008 financial crisis (one that did not depend on the Fed's growing its balance sheet and paying interest on excess reserves). Congress should also level the legal and regulatory playing fields for privately provided currencies, such as cryptocurrencies or precious metals, so that people can more easily choose whichever money best suits their needs.

Additionally, Congress should repeal the Fed's financial stability mandate and give the Fed a clearly defined, easily monitored, narrow monetary policy mandate that would no longer require active management of the economy. A total nominal spending mandate, for example, would pair the Fed's control over the total flow of credit with the overall nominal spending in the economy. This change would allow Congress to hold the Fed accountable for monetary policy blunders while giving the Fed a passive role that no longer requires actively managing interest rates, employment, or the price level. Such a rules-based framework would effectively restrict the Fed to responding to changes in the demand for money and nothing else. It would, therefore, avoid the many problems faced by central banks that try to actively manage the price level, employment, and other macro variables, all of which are regularly affected by nonmonetary factors.

REGULATIONS THAT PUSH UP PRICES

Aside from specific reforms for the Fed and monetary policy, if Congress responds inappropriately to the recent price increases, it could mistakenly worsen the economic problems that Americans are now facing and prolong the recovery. Pandemic-related disruptions have been driving price increases in specific market segments, and policies that fail to mitigate those specific disruptions run the risk of making it even more difficult for people to get the goods and services that they need. Moreover, Congress can address the supply disruptions in those specific markets in numerous ways.

For instance, Congress and the administration should promote freer trade by reducing both tariff and nontariff trade barriers. International trade is generally driven by the ability of people in various countries—through comparative advantages—to deliver lower-priced goods to consumers. If policymakers want to lower consumers' costs, they can encourage more trade by eliminating tariffs and nontariff barriers. (Between 2018 and 2020, for instance, Americans paid $7.5 billion in extra steel tariffs.)

Separately, numerous government regulations exist that drive up consumer prices, including those for food and energy, two of the main drivers of the overall price level. If Congress is concerned with higher consumer prices, now is the perfect time to start eliminating the countless government-imposed economic roadblocks that put upward pressure on prices. For instance, the federal government regulates a long list of consumer and commercial appliances, including refrigerators, air conditioners, furnaces, televisions, showerheads, ovens, toilets, and light bulbs. These regulations prioritize efficiency over other preferences that customers and businesses might have, such as safety, size, durability, and cost. In some cases, Americans are still paying for bad policies enacted decades or

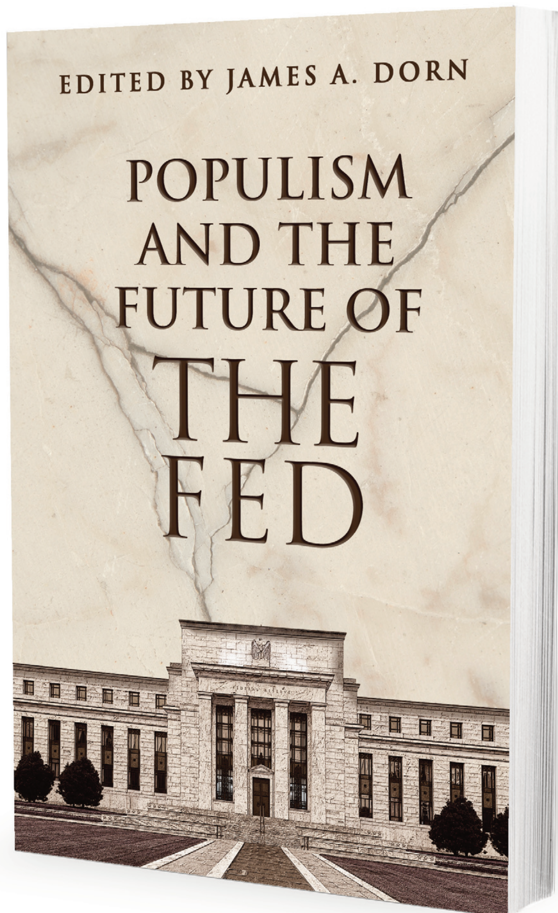
even more than a century ago—the Jones Act, for instance, was passed in 1920 and mandates that any goods shipped by water between two points in America must be transported on a U.S.-built, U.S.-flagged vessel with a crew that is at least 75 percent American. By preventing foreign competition, the Jones Act drives up costs for no material economic or national security benefit.

> Congress should also allow private businesses to produce more energy.

Congress should also allow private businesses to produce more energy, therefore placing downward pressure on prices. For example, Congress can allow open access to energy exploration of federal waters and lands, expand free trade for energy resources, and eliminate regulations and taxes that discourage the use of conventional fuels. Congress should also prevent all executive branch agencies from restricting access to energy resources through policies such as canceling the Keystone pipeline.

THE FED'S DIFFICULT TASK

These types of reforms may give little comfort to those who want immediate relief from the high inflation that currently exists, but the Fed is already doing the only thing it can to fight inflation. It has tightened its policy rates in three consecutive meetings, doing all it can to slow down the overall flow of credit and slow inflation. The dangers, of course, are that supply-side problems have not fully abated, and tightening the overall flow of credit too much could throw the economy into a major downturn. This last quandary alone should be enough for members of Congress to recognize that it is long past the time for a better monetary system, one that does not depend so heavily on any government agency to actively manage money and the economy. In the meantime, under the existing system, Americans can only hope that the Fed does not slow the overall flow of credit too much and that their political representatives finally refrain from expansionary fiscal policy. ■



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