Section 5: Monetary Policy That Holds the Fed Accountable

Congress created the Federal Reserve in 1913 to put an end to financial crises and severe recessions. But some of the nation's worst economic crises have occurred since then, and recessions haven't become shorter or less frequent. The U.S. economy suffered its most severe bout of deflation during the early 1930s and endured its highest peacetime inflation rates in the late 1970s—and is again enduring high peacetime inflation rates today. Despite the Fed's failures, Congress has tended to further expand its discretionary powers.

So long as Congress is inclined to delegate responsibility for conducting monetary policy and limiting financial instability to the Fed, there is much it can and should do to improve the Fed's performance. For instance, Congress can narrow and clarify the Fed's legislative mandate and require that the Fed implement rules-based monetary policy. It can also level the current privileged position that the U.S. dollar holds in competition with other potential means of payment so that the Fed faces competitive pressure to preserve, and perhaps enhance, the dollar's attractiveness as both a domestic and an international exchange medium.

THE PROBLEM

Good monetary policy helps America's workers, retirees, and savers by ensuring that the economy does not stall because of an insufficient supply of money. It also helps Americans by safeguarding against excessive money creation that can increase inflation and promote unsustainable booms. To manage the money supply responsibly, the Fed should strive to maintain a stable flow of total spending—enough to keep general business earnings from either racing ahead of, or falling short of, the costs of producing current output. To conduct monetary policy responsibly, the Fed also should supply money in a manner that avoids favoring specific firms, industries, or sectors of the economy over others. If it were to conduct policy in this manner, the Fed would place only the smallest possible footprint on economic activity, avoiding as much as possible any tendency to influence the profits and losses of specific enterprises, favor government over private investment, create moral hazard problems, or transfer financial risks to taxpayers. Finally, the Fed should conduct monetary policy in a transparent manner, with real accountability to citizens through their elected representatives. Throughout much of its history, the Fed has failed to meet these requirements, and Congress has failed by not compelling it to meet them.

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The so-called dual mandate calls for the Fed to achieve both "price stability" and "maximum employment." Because the Fed is also responsible for achieving financial stability, it really operates under a triple mandate.[1] All three mandates are ill-defined, and depending on how they are defined, they may also conflict with one another. Consequently, the Fed enjoys enormous discretion in interpreting and performing its duties, and Congress often lacks any means for holding the Fed accountable for fulfilling its responsibilities. Furthermore, because both the behavior of the price level and the extent of employment depend not only on the Fed's decisions but on factors beyond its control, it is unreasonable to blame the Fed for every instance in which these factors vary from some ideal. At the very least, therefore, Congress could improve monetary policy by holding the Fed responsible for the behavior of variables over which it exercises substantial control.

More narrowly, the Fed's price stability mandate is problematic because changes in the price level can also reflect changes in the scarcity of real goods and services. In other words, changes in the price level or in unemployment may not be evidence of poor Fed performance. In an economy experiencing rapid productivity growth, for instance, a low and perhaps even negative rate of inflation reflects rapidly falling costs and makes it easier for everyone to reap the benefits of those falling costs. Adverse supply shocks, on the other hand—like those caused by a war or the COVID-19 pandemic and related government shutdowns—cause prices to rise even when the demand for goods is not growing rapidly. A central bank that tightens monetary policy to check such supply-side based inflation only adds insult to injury because it provides even less money to purchase even scarcer items.

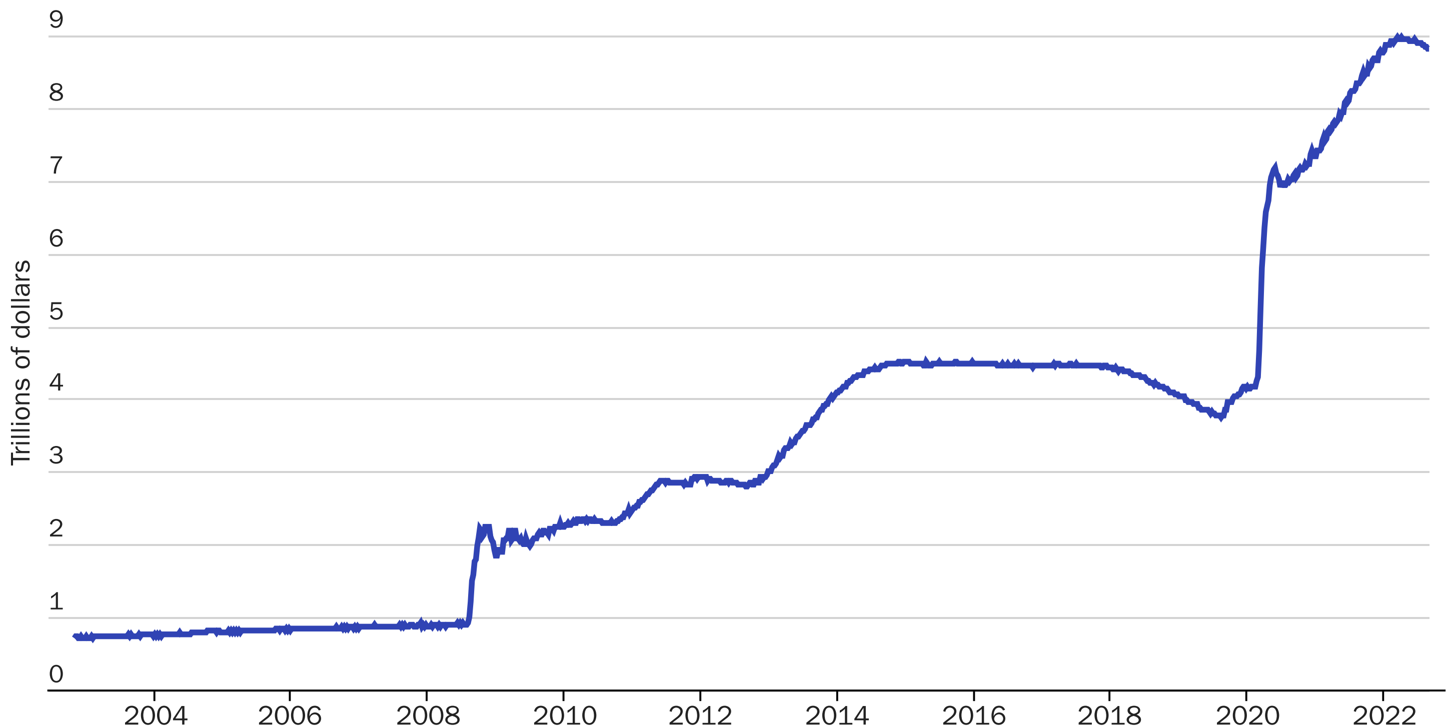
Separately, the excessive amount of discretion that Congress has bestowed on the Fed has allowed it to alter its operating framework in a manner that has seen its balance sheet grow to roughly 10 times its pre-2008 size (see Figure 5). The Fed's new operating framework, known as a "floor" system—has provided banks with a new risk-free investment choice, at a relatively high rate of return, thus causing banks to hold more funds as reserves. As interest rates rise, the Fed will have to pay larger and larger interest payments to banks to control inflation, an arrangement that increases the Fed's political risk and threatens its operational independence.

The new floor system also divorces the Fed's monetary policy stance from the size of the Fed's balance sheet by allowing the Fed to purchase as many assets as it would like, all while paying firms to hold on to the excess cash that these purchases create. This framework can all too easily allow the Fed to be a pawn of the Treasury Department. Put differently, the Fed's status quo operating system increases the risk that the Fed's quantitative easing (QE) powers will be abused for non-macroeconomic purposes, such as the funding of backdoor government spending.

Today, thanks to a Standing Repo Facility that the Fed established in 2022, there is no reason why the Fed cannot eventually undo all the post-2008 growth in its balance sheet.[2] Nor is there anything else to prevent it from returning

Figure 5

Federal Reserve's balance sheet has grown to roughly 10 times its pre-2008 size



Source: Board of Governors of the Federal Reserve System, "Assets: Total Assets: Total Assets: Wednesday Level," Federal Reserve Bank of St. Louis, 2022.

to a "scarce reserves" operating framework. In such a regime, instead of holding substantial reserve balances, banks strive to economize on reserves while turning more often to either the private repo market or the Fed's Standing Repo Facility to make up for occasional, temporary reserve shortages. The Fed's QE powers would then be correspondingly limited: although those powers would remain substantial so long as rates are at the "zero lower bound"—the only circumstance in which QE may be macroeconomically warranted—it would not possess them otherwise.

> "Congress could improve monetary policy by holding the Fed responsible for the behavior of variables over which it exercises substantial control."

A scarce reserve regime therefore enjoys the distinct advantage over a "floor" system of avoiding the risk that the Fed's QE powers will be abused for non-macroeconomic purposes. To compel the Fed to return to a scarce reserve regime, Congress should insist that the Fed follow the 2006 Financial Services Regulatory Relief Act, a law that stipulates that the rate of interest the Fed pays on reserve balances should not "exceed the general level of short-term interest rates."

SOLUTIONS

The U.S. dollar has long been the preferred payments medium throughout the United States as well as in many international markets. Congress should do all that it can to preserve that high standing by seeing to it that the Fed is a good steward of the dollar. To do this, we recommend the following:

- **Narrow the Fed's statutory mandate.** Congress should replace the Fed's dual mandate with a single stable spending mandate. The mandate would require the Fed to maintain a stable, if steadily rising, level of total spending on goods and services or, in other words, a stable dollar value of national income. Congress should also repeal the financial stability mandates that it gave to the Fed in Title I of the Dodd–Frank Act.
- **Require the Fed to follow a policy rule.** Congress should require the Fed to implement a simple rule that Congress can easily monitor and use to hold the Fed accountable. The rule should require the Fed to commit itself to maintaining a specific growth rate for nominal gross domestic product (NGDP), 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 NGDP somewhere in the range of 3–5 percent.
- **Shrink the Fed's balance sheet and reestablish a "scarce" reserve regime.** In a scarce reserve regime, instead of holding substantial reserve balances, banks would economize on reserves. To make up for temporary reserve shortages, banks would turn to either the private repo market or the Fed's Standing Repo Facility. To ensure that the Fed returns to a scarce reserve regime, Congress should insist that the Fed follow the 2006 Financial Services Regulatory Relief Act, a law that stipulates that the rate of interest the Fed pays on reserve balances should not exceed "the general level of short-term interest rates."[3]

SUGGESTED READING

Inflation: A Brief Look Back, and a Path Forward by Norbert J. Michel, *Cato at Liberty* (blog), Cato Institute, November 19, 2021.

Menace of Fiscal QE by George Selgin, Washington: Cato Institute, 2020.

The Fed's New Repo Plan by George Selgin, *Alt-M*, May 2, 2019.

Give the Fed a Single Mandate: Monetary Neutrality by Norbert J. Michel, Heritage Foundation Backgrounder no. 3367, April 24, 2019.

Floored!: How a Misguided Fed Experiment Deepened and Prolonged the Great Recession by George Selgin, Washington: Cato Institute, 2018.

Less than Zero: The Case for a Falling Price Level in a Growing Economy by George Selgin, Washington: Cato Institute, [1997] 2018.

Federal Reserve's Expansion of Repurchase Market Is a Bad Idea by Norbert J. Michel, Heritage Foundation Issue Brief no. 4261, August 14, 2014.

Has the Fed Been a Failure? by George Selgin, William Lastrapes, and Lawrence White, *Journal of Macroeconomics* 34, no. 3 (2012): 569–96.