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 standing lending facilities so that ad hoc emergency Fed lending, either to banks or to nonbanks, is unnecessary;
- 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, extraordinary lending, and large-scale open-market purchases;
- end the Fed's "floor" operating system by enforcing the 2006 Financial Services Regulatory Relief Act's provision stipulating that the rate of interest the Fed pays on reserve balances should not "exceed the general level of short-term interest rates," where that "general level" is understood to refer to risk-free overnight market rates;
- encourage the Fed to establish a truly "level playing field" between bank-supplied payment media and nonbank digital alternatives, especially by allowing nonbank "fintech" firms to have master accounts with it; and
- prevent the Fed from issuing its own "digital" currency, or from allowing ordinary persons to have accounts with it, to encourage competition and innovation in the dollar digital currency market, which is the best means for ensuring that the U.S. dollar remains the world's most efficient currency medium.

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 can 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 as being at least roughly consistent with responsible liquidity management. But the dual mandate's ambiguity prevents it from clearly delimiting the Fed's duties, as understood by Congress, much less as serving as a guide to whether the Fed is performing those duties well.

A single mandate to achieve *either* maximum employment *or* stable prices is not a good alternative. 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. A price stability mandate, on the other hand, might compel the Fed to stabilize prices even when doing so does more harm than good, as is especially likely to happen when prices are prevented from rising in response to adverse supply shocks.

Instead, Congress should replace the dual mandate with a single "stable spending" mandate, calling on the Fed to maintain a stable, if 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 will 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 steps to be taken when they fail to meet those targets.

Designing a rule appropriate to a stable-spending mandate is, fortunately, very straightforward. The simplest option is for Congress to require the Federal Reserve to 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 incentives by which to enforce the rule could consist of performance-based rewards to the Fed's chair, and perhaps also to members of the Federal Open Market Committee—the committee within the Federal Reserve System that determines the direction of monetary policy. For example, the chair could be assigned a very modest base salary, with bonuses dependent on his or her success in meeting the Fed's policy targets.

Eliminate the Rationale for Ad Hoc Lending Facilities with Flexible Standing Facilities

Following the Great Recession, the Dodd-Frank Act reformed Fed emergency lending by limiting it to programs and facilities with "broad-based eligibility" while prohibiting lending to insolvent entities. But as the subsequent COVID-19 crisis showed, that reform still allowed the Fed to engage in all sorts of emergency lending, including lending to ordinary (Main Street) businesses, administered through various temporary and "ad hoc" lending facilities.

Although it may be less controversial than direct Fed lending to specific firms, the Fed's reliance upon ad hoc lending facilities is itself problematic, because it can arbitrarily favor certain *groups* of borrowers, because it can result in wasteful lending, and because it may mean costly delays in getting funds where they are needed. All these shortcomings were still evident during the 2020 crisis.

"Flexible" Fed standing facilities are an alternative to both direct Fed lending to individual firms and broad-based but ad hoc lending facilities. The Fed took an important step in this direction when it established its "Standing Repo Facility" in 2021. That facility allows banks to make up for reserve shortages by temporarily exchanging Treasury securities for them, at an interest rate set slightly above the upper limit of the Fed's target range. To absolutely dispense with any potential need for ad hoc facilities, the Fed should consider making a similar standing facility available to various nonbank counterparties, including municipalities, while also extending the range of collateral it stands ready to repo, subject to appropriate discounts or "haircuts" reflecting the illiquidity and riskiness of accepted collateral. Consistent with the Dodd-Frank require-

ments, the Fed should not under any circumstances be allowed to make risky loans, though it might assist in administering risky loans that are fully funded by Congress.

A sufficiently flexible set of Fed standing facilities should allow the Fed to address even extreme liquidity needs, automatically and without delay, and without appearing to favor particular groups of borrowers, with no need for supplementary lending arrangements.

Audit the Fed's Performance

As an agency empowered by Congress to maintain a liquid financial system, the Federal Reserve 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 the 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.

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. Such clarification is especially important today owing to the Fed's switch to a "floor" operating system during the Great Recession. Under the new system, the Fed enjoys practically unlimited powers of quantitative easing (QE), meaning that it can buy as many assets as it likes while still controlling inflation with appropriate

changes in the interest rates it pays on bank reserve balances and on its "reverse" repos. The Fed's heightened QE powers will increasingly tempt politicians to try to get the Fed to employ them to finance backdoor spending, and not solely for macroeconomic purposes.

Reestablish a Scarce Reserve Operating System

Mainly as a result of various rounds of QE, the Fed's balance sheet is now roughly 10 times its size in 2007. That growth has included an almost equal increase in banks' reserve balances. Although nominal bank reserves are bound to increase as the Fed's balance sheet grows, the fact that the banks' *real* (inflation-adjusted) reserve balances have also grown substantially reflects the influence of the Fed's decision to pay interest on bank reserves at a rate generally exceeding risk-free short-term lending rates, which has made reserves more attractive relative to other assets banks might otherwise acquire.

After the Great Recession, the Fed made an effort to shrink or "unwind" its enlarged balance sheet to the smallest size consistent with a "floor" operating system. But before the unwind went very far, reserve shortages broke out that brought it to a premature conclusion. Today, thanks to the Fed's Standing Repo Facility, there is no reason why the Fed should not be able to eventually undo *all of* the post-COVID-19 growth on its balance sheet.

But the Fed should be encouraged to go further, by continuing its unwind with the aim of reestablishing a "scarce" reserve regime. In such a regime, instead of holding substantial reserve balances, banks would economize on reserves while turning more often to either the private repo market or the Fed's Standing Repo Facility to make up for 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 their "zero lower bound"—the only circumstance in which QE may be macroeconomically warranted—it would not possess them otherwise. 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 nonmacroeconomic purposes.

Congress has the power to compel the Fed to return to a scarce reserve regime. To do so, it merely has to enforce the 2006 Financial Services Regulatory Relief Act's provision stipulating that the rate of interest the Fed pays on reserve balances should not "exceed the general level of short-term interest rates." At present, the Fed is violating the spirit of that law by allowing itself to treat its own, administered "discount rate," which it sets well above equivalent private market rates, as representing "the general level of short-term rates." Congress should put a stop to this unlawful sham.

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.C. § 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 capital gains taxes. Congress should also repeal those parts of the U.S. Code, Title 18, that make it illegal to make, possess, or circulate private metal coins or tokens that resemble ("government-issued" or something similar) 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.C. § 485.

Congress should also make it easier for nonbank financial technology firms, or "fintechs," to compete with banks in supplying dollar-based digital media. In particular, it should encourage the Office of the Comptroller of the Currency to renew its efforts to provide fintechs with charters especially designed to accommodate their business models, and the risks those models entail; it should also encourage the Fed to make it easier for nonbank firms possessing such charters to open Master Accounts with it.

Finally, Congress should prohibit the Fed from issuing its own digital currency or supplying retail accounts to ordinary citizens. Direct Fed competition with private digital payment media suppliers will tend to stifle entry into the digital currency market, with the long-run consequence of reduced payments system efficiency and innovation. In the long run, a vigorously competitive, private market for digital dollars, rather than one dominated by a public monopoly, is our best hope for preserving the dollar's status as the world's preferred official currency medium.

Suggested Readings

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