

Monetary Policy Reforms for the United States

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Introduction

As a result of the pandemic, the US fundamentally has two sets of issues that they need to learn how to handle. The first set of issues surrounds the immediate financial crisis that came about due to the precipitous decline in economic activity. The second set of issues all arise from long term problems that will remain after the pandemic is over, where the US will have interest rates stuck near zero, large amounts of new debt, and an economy running significantly below potential.(1) To deal with the first set of problems, I propose three policies the Federal Reserve should immediately adopt to head off any potential disaster, which they have largely already done. To deal with the second set of problems, I recommend three policy experiments, each one designed to handle one of the persistent economic dilemmas that will remain after the crisis which will hopefully teach us how best to manage the economy over the long run.

Dealing with the Immediate Financial Crisis

In order to avoid a major financial catastrophe in the midst of a horrible pandemic, I propose three policies the Federal Reserve should immediately adopt (which they already largely have) that will prevent any major crisis from arising over the short term. The first policy the Federal Reserve needs to adopt is to print a lot of money and buy a lot of bonds over a very short period of time. The Federal Reserve initially announced it was buying \$700 billion in new bonds in another round of QE, and then on March 23rd, 2020 made those purchases open ended by buying nearly \$2 trillion by the end of the month. The amount being purchased declined over the following two months, and in June the Federal Reserve promised to continue purchasing bonds worth \$120 billion each month going forward.(2) This is exactly what the Federal Reserve should be doing, but they could do even more, since ideally I would have the central bank buy substantially more bonds with printed money than the government issues in new debt. Currently, the Congressional Budget Office projects deficits worth \$3.7 trillion in the current fiscal year, and the Federal Reserve is buying slightly less than that through their existing programs.(3) The Federal Reserve did create a massive new program to distribute loans to individuals, businesses, and governments worth \$2.3 trillion, but this is very different from doing something like QE, since those loans are being used to support other entities that usually do not get help from the Federal Reserve and not going toward more conventional recipients by buying more government debt.(4) That means in theory, even though the Federal Reserve is currently providing a tremendous amount of assistance, they could be doing a bit more since Japan did QE worth much more than their annual deficit for several

years without any problems, and the US could learn from their experience by being even more aggressive than they are now.(5)

The second policy the Federal Reserve needs to adopt is to promise to do whatever it takes to avoid any financial crisis from developing. After their latest FOMC, Jerome Powell said that,

“At the Federal Reserve, we are strongly committed to using our tools to do whatever we can, and for as long as it takes, to provide some relief and stability, to ensure that the recovery will be as strong as possible, and to limit lasting damage to the economy.” – Jerome Powell, June 10th, 2020

This strong statement basically repeats the famous words that former ECB President Mario Draghi used to calm European markets after the 2008 financial crisis, where he stated that,

“Within our mandate, the ECB is willing to do whatever it takes to preserve the Euro. And believe me, it will be enough.” – Mario Draghi on July 26th, 2012 at a speech in London.

This statement by Mario Draghi had dramatic effects on the financial markets in Europe, where interest rates on government bonds in the most distressed countries fell substantially after that strategy was announced, so Jerome Powell did exactly what he should have done by repeating it again in the midst of this crisis. If buying a lot of bonds through quantitative easing helps ease the pressures on newly issued bonds, then declaring to do “whatever it takes” can help prevent any problems from developing in the market for existing bonds, and the Federal Reserve and Jerome Powell have managed to do exactly that during these difficult times.

The third policy the Federal Reserve needs to adopt is to continue these extraordinary measures indefinitely, not until the pandemic ends, but until the economy recovers and interest rates go above zero again. Fed Chair Powell already did this to some degree by including the phrase, “as long as it takes” in his previous statement, and again when announcing the projections of FOMC participants about the future path for interest rates in the US. In this Summary of Economic Projections, Powell reported that FOMC members expect the economy to turn around in the last half of 2020 and also expect that the recovery will last around two years in total, which means the FOMC members also expect to keep interest rates at zero over that entire time until 2022.(6) This means the Federal Reserve has given the impression that extraordinary measures like zero interest rates will continue for a significant period of time after the immediate pandemic ends, and has no real interest in withdrawing these aggressive new policy stances anytime soon.

Overall, then, the Federal Reserve is doing an excellent job in the immediate crisis. They are printing a lot of money and buying a lot of bonds, which is exactly what they should be doing, but perhaps could be doing even more QE than they are doing right now. Plus, the Federal Reserve Chair Powell has made it clear through his statements that they will do whatever it takes for as long as it takes to get the US through the crisis, which is a powerful way to calm the markets and avoid any financial catastrophe from developing.

Dealing with the Aftermath of the Pandemic

After the pandemic is over, the US will likely have to deal with three persistent problems. Interest rates will likely be stuck at zero for an extended period of time, the amount of debt will have grown substantially during the crisis, and the economy will be running significantly below potential resulting in unemployment rates much higher than they were before the pandemic hit.(7) I recommend that the Federal Reserve and US government attempt three different policy experiments, one for each individual problem, so that policy makers can quickly learn the best way to confront any lingering economic difficulties.

First Policy Experiment: Allow the Fed to Make Direct Payments to Individuals

Interest rates will likely be stuck at zero for a long time, so the Federal Reserve will need new tools to manage the ebbs and flows of the business cycle over the long term as well. This means the first policy experiment should provide the Federal Reserve with some new policy tools by giving them some control over fiscal policy. In particular, the Federal Reserve should be allowed to distribute modest uniform monthly payments to each individual in the country.

The US has already started down this route by giving \$1,200 one time payments to each adult and \$500 payments for each child for families that fall below a certain income,(8) but this experiment would allow the Federal Reserve to hand out perhaps \$100 a month to all individuals (both adults and children regardless of income), and it would be the Federal Reserve and not Congress or the President deciding when to offer it and when to take it away. This would limit the Federal Reserve's control over fiscal policy to about 2% of GDP, which is enough to have an impact on the economy without risking financial ruin if things go wrong.(9) If Congress was worried about ceding too much control over fiscal policy, then they could put a one year time limit on any dividend payment to individuals, where if Congress did not pass legislation extending the monthly payments approved by the Federal Reserve within that time, then they would automatically expire.

This experiment would provide significant benefits during the pandemic, since it would provide extra support to households on a monthly basis, which is especially important for low income households during this difficult time. This would also be helpful because the US would be able to create this stimulus knowing it would be easier to withdraw later, since the Federal Reserve is better protected from political pressures that might encourage them to extend the stimulus indefinitely. Most importantly, however, this experiment would be particularly critical during a future crisis, since institutionally the Federal Reserve can react faster than Congress and is better situated to monitor and respond rapidly to developing economic trends. Plus, by setting up this power ahead of time, the Federal Reserve could create the administrative infrastructure now to distribute the monthly payments to every individual, rather than having to set it up in real time just as the economy needs those payments most.

If interest rates were stuck at zero for a long time, then fiscal policy would be an important tool of counter cyclical policy and giving the Federal Reserve some control over this policy lever would speed up the immediate response to the crisis since you would bypass the usual legislative process. Plus, if

interest rates did go above zero, this would still be valuable because of the long policy lags in interest rate changes, where even if the Federal Reserve responds right away, cutting interest rates still does not have its full impact on the economy until many months later. Allowing the Federal Reserve to initiate direct payments would allow them to have a powerful impact on the economy much more quickly.

This experiment would then be beneficial regardless of what happens. It could provide additional fiscal stimulus to an economy in dire need on a monthly basis that could be easily taken away at the most opportune time. Plus, this experiment would dramatically speed up the counter cyclical policy response in any future crisis by taking advantage of the streamlined institutional structure at the Fed and by having the administrative mechanisms to pass out monthly payments to all individuals created ahead of time. In addition, this experiment would be valuable if interest rates remain at zero and fiscal policy is one of the few tools available to the Fed, but also if interest rates go above zero and the Fed wants to bypass the long policy lags of interest rate cuts.

Second Policy Experiment: Extending the Time the Fed Holds on to Government Bonds

Since the US is likely to incur a lot of new debt in the midst of the pandemic, the second policy experiment would test to see if the US could pay off some of that debt with printed money that remains permanently in the economy. They would do this by publicly extending the length of time the Federal Reserve holds on to the government bonds it previously bought with printed money during its QE campaigns. Even though the government needs to do whatever it takes in the short run to deal with the pandemic and not worry about the cost, eventually these extraordinary measures will need to be paid for and the US will have to deal with a lot of newly issued government debt as a result. The US can deal with any costs arising from this crisis with little trouble since interest rates are so low and investors want to buy so much US Treasury debt, and any future problems are likely decades away. However, if there does end up being an enormously costly new economic crisis every ten years, then eventually the US will run out of fiscal space to issue new debt, and might have to consider paying for the debt with printed money rather than tax money in a few decades.(10)

This experiment would basically see if this approach were feasible over the long term. It might sound radical, but the Federal Reserve has already been printing money and buying up a lot of bonds through QE,(11) and the only difference between what we have been doing in the past and what this experiment would attempt, is that the prior rounds of QE were supposed to be removed from the economy later, while this experiment would leave the printed money in the economy forever. In the past rounds of QE, the Federal Reserve has claimed this money printing was only going to be temporary but in practice, the Federal Reserve has only been able to remove about 20% of the money printed in previous rounds of QE even at the peak of the last business cycle.(12) This means that the Federal Reserve probably will not be able to remove the money printed in the rounds of QE being done over the past several months, let alone remove the money printed from the previous rounds of QE, so realistically the printed money is going to stay in the economy for the foreseeable future no matter what the Federal Reserve actually claims. This experiment would basically have the Federal Reserve just explicitly admit to what is probably already obvious to investors anyway, so it will most likely have little impact on the market or the economy as a result.

The Federal Reserve should proceed incrementally with the experiment, where they could perhaps hold on to 5% of the bonds they currently own for 10 years, then raise that limit to 25%, then to 50%, then to 100%. Soon after, they could increase the length of time they plan to hold onto those bonds to 25 years, then 50 years, then finally indefinitely. The underlying debt problem is far enough away, that the US probably does not need to do this experiment during the crisis, but once the pandemic is over, and it becomes clear the Federal Reserve will not be able to remove all the QE it did during the pandemic, then the central bank might as well see what happens when you finally admit to what you are actually doing. Ideally, Japan would do this experiment right away, which means the US would not be the first to try this, especially since Japan is much farther along in this process already, where they have been dealing with interest rates at or near zero for more than 20 years and have already accumulated debt worth 238% of GDP.(13)

The experiment would be useful then because it would teach us that debt can be permanently paid off with printed money, which means there is no need to worry about a debt crisis far into the future. If QE is temporary, then the Federal Reserve sells the bonds it previously bought back to investors and the US government will need to pay them off with tax money. If, however, QE is permanent, then the Federal Reserve holds onto the bonds in perpetuity and the Treasury never needs to pay back any principal, while the interest that gets paid on those bonds to the Federal Reserve ultimately just gets transferred back to the Treasury Department later. This means the government never incurs any costs from debt held by the Federal Reserve, and this debt is permanently paid off with printed money. Therefore, we would now know that any future debt crisis can be avoided over the long term since the Federal Reserve can just print more money if the debt gets too large.

This would also be important over the short run because this means the US would be able to do more fiscal stimulus right now. Governments always feel pressure to make deficits sustainable over the long term to keep any debt crisis from arising in the future, so they often cut back budget deficits as soon as the immediate crisis subsides.(14) Once the fear of a debt crisis goes away, then the rest of government can do more fiscal stimulus now to help the economy recover, which might be especially important if interest rates remain near zero for a long period of time. The next question then is how much fiscal stimulus should the government do now that there is no fear of a future debt crisis.

Third Policy Experiment: Gradually Increase the Amount of Fiscal Stimulus After Pandemic Ends

Since the economy is likely to be well below potential after the pandemic is over, this leads to the third policy experiment where governments need to gradually expand fiscal stimulus once deficits reach post crisis levels, to see how much it can speed up the recovery without sparking higher inflation. If the US does the second experiment, and learns it no longer needs to fear a future debt crisis, then this allows them to do more fiscal stimulus over the short term. The dilemma then becomes figuring out how much fiscal stimulus can the government safely do. Ideally, it wants to speed up growth and quickly reduce unemployment, but if they take things too far, then this could lead inflation to start rising. In the past, fear of a future debt crisis has caused deficits to be reduced far too quickly, so in general governments have been biased towards doing too little fiscal stimulus. The recent increase in the deficits due to the Trump tax cuts and spending increases shows that higher deficits can help the economy even at the

peak of the business cycle when unemployment was already low, so this means we can probably do more fiscal stimulus than we think without causing any trouble.⁽¹⁵⁾ Now we just need to repeat this experiment and make it explicit in order to speed up the recovery and gain valuable knowledge about how much fiscal policy can really do to help the economy perform better over both the short and long term.

Conclusion

During the crisis, the Federal Reserve needs to take aggressive measures to avoid any immediate financial upheavals from the pandemic, and should be printing money and buying bonds to the point that this exceeds the amount of new debt being issued. In addition, the Federal Reserve needs to promise to do whatever it takes to get through the crisis and then maintain these extraordinary measures as long as it needs to in order to aid in the recovery afterward. The Federal Reserve is basically already doing this by taking such dramatic steps to improve the economy (though they could still be doing more QE), and also through their recent pronouncements declaring their intention to do even more if necessary, as well as their plan to continue these extraordinary measures for a considerable period of time after the immediate pandemic ends.

After the crisis, the United States needs to do three policy experiments. First, in order to deal with interest rates stuck at zero, the Federal Reserve needs to gain some control over fiscal policy by being able to distribute equal cash payments directly to individuals. That way it has a tool both for this crisis and any future crisis that allows them to manage the ebbs and flows of the business cycle that does not involve changing interest rates. Second, the Federal Reserve needs to do an experiment to see if the new debt being issued by the government can be paid back permanently with printed money by extending the length of time they plan to hold onto the government bonds they have already purchased. This would test to see if permanent QE would have any different effects on the economy than the temporary QE we have already been doing for a long time. Third, once we know that any future debt crisis can always be avoided by printing more money, the government needs to gradually increase the amount of fiscal stimulus once deficits reach post crisis levels, to see how far fiscal stimulus can go in speeding up the recovery and reducing unemployment without raising inflation.

Combined these measures will not only get us through this crisis, but also help us throughout the recovery and during all future crises by teaching us how to better manage the economy in these difficult and unique times. Ultimately the key to effective economic policy is learning as quickly as possible what works and what does not, so that we can pivot quickly from the mistakes we will inevitably make in the immediate crisis and improve our policy response dramatically once the next crisis hits. This ensures progress over the long term and provides a strong rationale for taking these extraordinary measures and attempting these policy experiments as quickly as possible.

End Notes

#1 – Interest rates in the US remained below 0.5% from 2009 to 2016, and fell below 0.25% once the pandemic hit in March of 2020. Since this crisis appears to be extremely severe, just as the financial crisis was, then this means interest rates are likely to remain near zero for an extended period of time. The Congressional Budget Office Projects that the new measures enacted to deal with the pandemic will ultimately cost the government about \$2.8 trillion (CBO 2020b) over the next two fiscal years (about 14% of GDP) and the total deficit will reach \$3.7 trillion (CBO 2020a) in fiscal year 2020 (about 18% of GDP). In April of 2020, the unemployment rate rose to 14.7% up from 3.5% in February of 2020, and even though the unemployment rate declined to 13.3% in May of 2020 (Trading Economics 2020), the economy still has a long ways to go until full employment is reached again, and this means that the economy will likely be running below potential for an extended period of time as well.

#2 – On March 15th, 2020 the Federal Reserve announced it would be buying \$500 billion in Treasury bonds and \$200 billion in mortgage backed securities over the coming months. On March 23rd, 2020 the Federal Reserve made this commitment open ended and bought nearly \$2 trillion in bonds by the end of the month. The Federal Reserve issued guidance that indicated they would buy \$80 billion a month in Treasuries and \$40 billion a month in mortgage backed securities going forward. (Cheng et al 2020).

#3 – The Congressional Budget Office projects the total deficit in fiscal year 2020 will reach \$3.7 trillion (CBO 2020a), while the Federal Reserves balance sheet has grown by about \$3 trillion since the pandemic first hit the US (Trading Economics 2020). If the Federal Reserve keeps buying bonds worth \$120 billion a month until the end of fiscal year 2020 in September (only 3 ½ months away), then the total amount of bond purchases will be just slightly less than the total amount of new debt getting issued, when ideally it would be a bit more than that.

#4 – The Federal Reserve helped individuals borrow money by creating the Term Asset Backed Securities Loan Facility (TALF) which loans money to institutions owning securities backed by student loans, auto loans, credit card loans, and small business loans. The Federal Reserve helped businesses by creating the Primary Market Corporate Credit Facility (PMCCF) that allows the central bank to lend directly to large businesses by buying newly issued corporate bonds. The Federal Reserve is reaching out to help small and medium sized businesses through its Main Street Lending Programs, which targets businesses too large for the Paycheck Protection Program but too small for the Fed's programs designed to help large businesses. The Federal Reserve is also lending directly to state and local governments through its Municipal Liquidity Facility, which includes US states, counties with more than 500,000 residents, and cities with more than 250,000 residents (Cheng et al 2020).

#5 - In 2014, the Bank of Japan announced it was expanding its program of quantitative easing so that now the bank would buy 80 trillion yen worth of bonds every year (about 15% of GDP) and did not revise this plan until 2016, at which point it switched to a system of yield curve control rather than targeting specifically 80 trillion yen a year. Between 2014 and 2016, the government of Japan ran budget deficits worth 20 to 30 trillion yen (about 4-6% of GDP), which means the 80 trillion yen in QE was worth anywhere from 2.5 to nearly 4 times the value of the budget deficit. Since 2016, the amount of QE has

declined some over time, but still easily exceeded the overall budget deficit which was also declining. Core inflation remained below 2% in Japan every year except for a brief period after they raised their Value Added Tax from 5% to 8%.

#6 – The Summary of Economic Projections released by the Federal Reserve on June 10th, 2020 show that FOMC members generally expect that economic growth will be negative for 2020, but then start growing again in 2021. Jerome Powell in his June 10th press conference indicated that this meant FOMC members thought the economy would turn around in the second half of 2020. All but two FOMC participants indicated they would keep interest rates below 0.25% through 2022.

#7 – See end note #1.

#8 – The CARES act provided stimulus checks of \$1,200 for each adult as long as their income was below \$75,000 for single people or \$150,000 for adults, at which point it started to phase out. The legislation also provided \$500 for each child under the age of 17.

#9 – According to the Census Bureau, the population of the United States was 328 million in 2019. If each person got a total payment over the course of a year of \$1,200 that would ultimately cost around \$394 billion or about 2% of US GDP.

#10 – Debt as a percent of GDP went up from about 63% of GDP in 2007 to 103% in 2014, a rise of about 40% of GDP, and the current crisis could create debt worth a similar amount. If we assume the worst case by projecting that each major financial crisis creates new debt worth 40% of GDP, then the US is only two major crises away from having debt reach dangerous levels well above 150% of GDP that led to a bailout in Greece, and we might be in the middle of experiencing the first one right now. A second major crisis could occur in the next 20 years or perhaps two smaller crises could occur in the next 30 years, which means the US could run out of fiscal space in as little as 20 to 30 years, but it also might take decades longer if everything goes relatively smoothly.

#11 – The Federal Reserve announced its first round of QE in November of 2008, the second round of QE in November of 2010, and the third round of QE in September of 2012. To see how much QE the Federal Reserve has been doing in response to the pandemic see end note #2.

#12 – In the years before the financial crisis, the Federal Reserve's balance sheet slowly grew to about \$800 billion in 2008. After 6 years of QE, the Federal Reserve's balance sheet rose to about \$4.4 trillion, an increase of about \$3.6 trillion. In 2018, the Federal Reserve started to reduce the size of their balance sheet, and this amount ultimately fell to about \$3.7 trillion before starting to increase again in 2019, a fall of about \$700 billion, which is about 20% of the total increase (Trading Economics 2020).

#13 – In 2018, debt stood at 238% in Japan, and interest rates first went down to zero in 1999 and have remained at or below 0.5% since then (Trading Economics 2020).

#14 – The United States reduced their budget deficit from 8.4% of GDP in 2011 to 2.8% in 2014 after the financial crisis had subsided. Over approximately the same time period, Japan reduced its budget deficit

from 8.3% of GDP in 2011 to 4.5% in 2015. If you were to combine all the countries in the Eurozone, their total deficit fell from 6.3% of GDP in 2010 to 0.5% in 2018 (Trading Economics 2020).

#15 – Trump passed his tax cut into law in December of 2017 and passed his budget for fiscal year 2018 in March of 2018. The deficit rose from 3.2% of GDP before Trump took office in fiscal year 2016 up to 3.5% in fiscal year 2017, 3.8% in fiscal year 2018, and 4.6% in fiscal year 2019. Inflation during this time as measured by the core personal consumption expenditures (PCE) index rose by 2.0% or less compared to the same month the previous year in the following two years after the tax cut was passed. The unemployment rate fell from 4.1% in December of 2017 down to 3.5% in February of 2020, the lowest since 1969.

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