L. Downey, The Monetary/Fiscal Divide is Still Getting in Our Way

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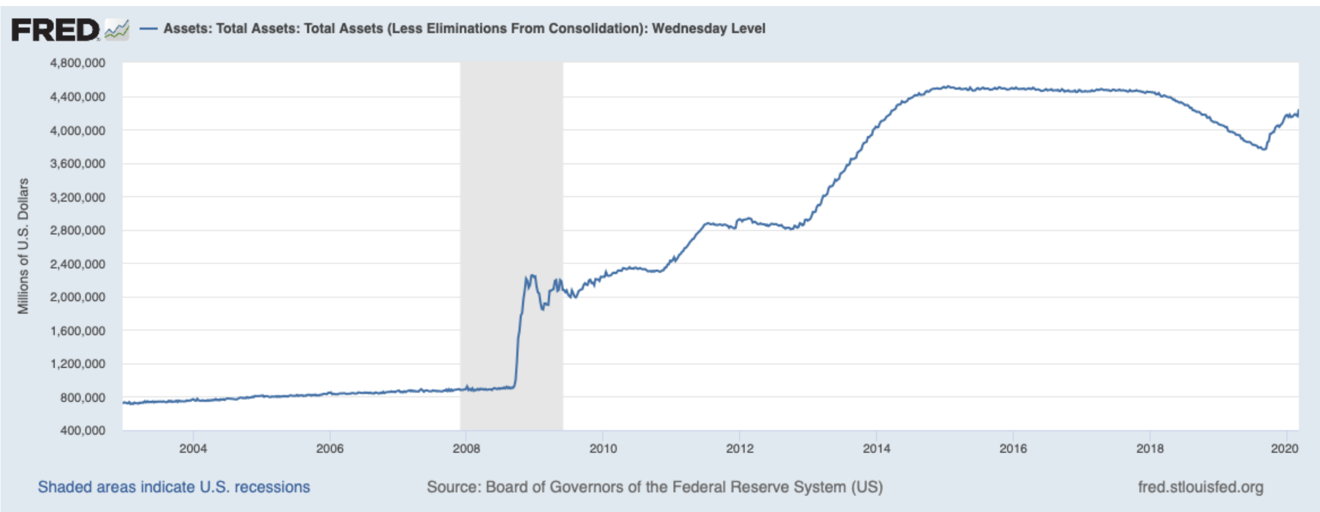
In the wake of the Great Financial Crisis (GFC) the Federal Reserve got creative. The Fed employed a set of 'unconventional' policies aimed at addressing the crisis within the given institutional structures and tools available. Those policies, including Large Scale Asset Purchases (LSAPs, commonly known as QE or "Operation Twist") and forward guidance, did constitute a significant break from prior policy approaches – take a look at the Fed's balance sheet over time – but they did not alter the fundamental structure of monetary policy. LSAPs were, after all, simply immense targeted open market operations (OMOs) and forward guidance was an internal change in communication policy.[1] In other words, when the GFC hit, the Fed innovated within existing structures to address the threat.



The Fed is taking exactly the same action to confront the Coronavirus. As one New York Times headline put it, "The Fed Deployed its 2008 Arsenal All in One Weekend." This should come as no surprise. While testifying to Congress before the Coronavirus hit the US, Chair Jerome Powell was asked what tools the Fed had available to fight the next economic downturn. He answered by pointing out that the current environment of low interest rates meant that cutting rates further would likely be insufficient to fight a downturn. He went on to say that, in such a situation, the Fed would have to employ the same tools it did in the wake of the Great Financial Crisis: forward guidance and large-scale asset purchases (LSAPs). "We will use those tools. I believe we will use them aggressively should the need arise to do so." And so they have.

In 2008 it was at least conceivable, if highly debatable, that the proper monetary policy response to a *financial* crisis was to inject a large amount of money into the *financial* sector. Can the same be said in the face of a global pandemic? In 2008, the Fed designed and executed its monetary policies to spur real economic activity. It purchased a huge amount of longer-term assets in an effort to push liquidity to businesses in the real economy. Today, in a world of social distancing, we don't need to jumpstart real economic activity, we need to freeze it. If we get that right, "production and spending must inevitably decline for a time." But so far, the Fed still wields the same tools, seeking to send large amounts of money into the economy via a small set of large financial institutions (primary dealers). Given the different nature of the two crises, this seems odd.

Nadav Orin Peer ended his post writing, "the public's financial health should come first." I couldn't agree more. Unfortunately, at the moment, it is very difficult, if not impossible, for the Fed to heed the call. The Fed's only conduit to supporting the financial health of society at large is via the financial markets: it can cut rates, change regulations, and buy and sell assets from large financial institutions. When it comes to Fed interventions, it's no wonder the financial sector comes first.

We have had twelve years to re-structure our financial architecture. After the Great Financial Crisis and the Eurozone Crisis, some called for legislatures to enable central banks to deposit money directly into the bank accounts of individual citizens: People's QE. Notably, executing this policy would be a lot easier if individual citizens were permitted to hold bank accounts at the central bank. Perhaps ironically, Ben Bernanke poo-pooed this notion not on the basis of economic theory, but by appeal to democratic theory. He wrote, "the distribution of what are effectively tax rebates should be subject to legislative approval, not determined unilaterally by the central bank." And he's right. But then should QE, the distribution of what is effectively an immense amount of credit to a small set of financial institutions, be determined unilaterally by the central bank? What Bernanke's comment reveals is that balance sheet policies, no matter to whom the money is distributed to, blur the monetary-fiscal divide.

Many economists in the wake of the GFC have called for increased monetary-fiscal policy coordination in emergency situations. Their proposals implicitly recognize the simple fact that there are macroeconomic policy strategies which the state *cannot* execute without monetary-fiscal policy coordination. The most obvious example involves money creation by the Fed for public spending, a central bank operation that some call "helicopter money" and Ben Bernanke dubs a "Monetary-Finance Fiscal Program." Instead of the Fed using new money to buy assets from large financial institutions to stimulate the economy, with helicopter money the Fed makes new money available for the legislature to spend—if they so choose, in one way or another, including sending a check to every citizen—something we've been hearing a lot about lately.

There is no existing institutional mechanism ready to facilitate such monetary-fiscal coordination. Congress did not act after the GFC. It did not heed the call to enable central banks to deposit money directly into the bank accounts of individual citizens. It did not heed the call to allow citizens to hold accounts at the Fed. It did not heed the call to enable soft monetary-fiscal coordination, in which the Fed runs the show, determining how much new spending it will finance but allowing Congress to decide if and how to spend it. Nor has Congress considered developing a national investment authority.

There are potential problems with all of these proposals, particularly the soft monetary-fiscal coordination proposals, but at least they are all attempts to learn from the structural limitations that American policymakers—monetary and fiscal—faced in addressing the Great Financial Crisis. Congress did nothing, and here we are. We face a whole new threat to the global economy and to global health, and still all the Fed can do is give money to large financial institutions.

In an earlier post, James McAndrews called for more fiscal action to stave off economic crisis: extend unemployment benefits, expand Medicaid and food stamps, etc. Some of his wishes have been granted since he wrote, and it's obvious now that we still need much more fiscal stimulus. But we should not let critiques of fiscal actions, or lack thereof, blind us to Congress's other macroeconomic responsibilities. The Fed may be an independent central bank, but it is unquestionably Congress's responsibility to govern monetary policymaking by setting the terms of the Fed's power. The Fed was established over a century ago as a banker's bank. At the time it was primarily a coordination mechanism for private banks. Today the Fed is, above all, the U.S. government's monetary policy authority. It should possess the powers and mechanisms necessary to safeguard and promote the financial health of the entire nation directly, not merely via the financial sector, and the democratic oversight to empower it to do so legitimately.

If the monetary policy response to coronavirus is similar the monetary policy response to the Great Financial Crisis, we should expect the outcomes to be similar. The financial sector will recover quickly and benefit handsomely. The rest of the economy will survive, with long lasting scars. We should learn from the GFC. Congress should improve the existing power and mechanisms for executing monetary policy: it should consider opening up the Fed to individual depositors, engage in 'People's QE', or convert the regional Federal Reserve Banks into regional investment banks. To fight the Great Financial Crisis, the Fed had to get creative in designing its approach to monetary policy. The time for Congress to do the same is long overdue.

1. Payment of interest on excess reserves was perhaps slightly different, as it constituted a change in powers of Fed to pay interest on excess reserves. However, this change was made by congress well in advance of the actual GFC. ↑