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COVID-19 Pandemic, Direct Cash Transfers, and the Federal Reserve

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The economic fallout from the pandemic of COVID-19 is likely to be large. Entire portions of the US economy are shutting down, and some forecasters are predicting that GDP will contract as much as 10 percent in 2020.[1] Jason Furman, former chair of the Council of Economic Advisers for President Obama, believes the contraction could be even worse and surpass the depths of the Great Recession of 2007–2009.[2] As a result, many are calling for a large government response, including direct cash transfers to households. There appears to be growing momentum for such programs, with Republican and Democratic senators calling for direct cash payments to households for the duration of the crisis. Even the White House is seriously considering this option.[3]

At the same time, the COVID-19 shock has accelerated the decline of interest rates to the point that it is impairing the ability of the Federal Reserve (Fed) to function. The Fed implements monetary policy by adjusting interest rates, both its overnight interest rate as well as longer-term interest rates, via large-scale asset purchase programs. Interest rates were already falling, but the COVID-19 shock simply hastened the decline by pushing the entire yield curve of interest rates close to 0 percent.[4] The Fed's operating framework, however, was designed for a positive interest rate environment with lots of space to cut interest rates. The Fed, in short, is becoming increasingly impotent at the very moment the economy needs it most.

Ironically, these growing calls for direct cash transfers and the mounting weakness of the Fed may be the very catalyst that brings about a much-needed overhaul of the Fed's operating framework. Over the past few years, some observers have been warning that the Fed needs to update its operating framework to include a level target and the ability to implement direct cash transfers in

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special situations like the current crisis.[5] They make the case that it is better for the Fed to provide any direct cash transfers because it is nimbler and more likely to do so in a rules-based manner.

That time has come, and this policy brief shows how to ensure that the overhaul of the Fed's operating framework can provide powerful countercyclical policy in a manner that is both systematic and based on rules. The overhaul consists of three main steps: First, the Fed needs to adopt a two-rule approach to monetary policy so that it can handle both positive and negative interest rate environments. Second, the Fed needs to adopt a nominal GDP level target so that it can stabilize dollar incomes and make up for past misses in its target. Finally, the Fed needs to be given a standing fiscal facility so that it can do direct money transfers, or "helicopter drops," to households once interest rates hit 0 percent. This feature cuts out the "middleman" of monetary policy during severe economic downturns. These three steps are outlined in greater detail in this policy brief.[6]

A THREE-STEP PLAN TO OVERHAUL THE FED'S OPERATING FRAMEWORK

The Fed's operating framework—defined here as the instruments, tools, and targets the Fed uses in its conduct of monetary policy—is need of an overhaul, and the overhaul suggested here keeps the Fed as the main institution doing countercyclical macroeconomic policy. Because the public already views the Fed as playing this role, this feature would provide continuity. To make this happen, the overhaul requires the following three steps.

Step 1: The Fed Adopts a Two-Rule Approach to Monetary Policy

This first step would make the Fed's operating framework robust to both positive- and negative-interest-rate environments. Specifically, the Fed would follow a version of the Taylor rule when interest rates are above 0 percent, since this rule uses an interest rate target as the instrument. The Fed would follow the McCallum rule when interest rates are at 0 percent or less, since this rule uses the monetary base as the instrument. The McCallum rule, consequently, would govern how the Fed conducts its helicopter drops and when tapping the standing fiscal facility. This two-rule approach to monetary policy would be explicitly added to the Federal Open Market Committee's *Statement on Longer-Run Goals and Monetary Policy Strategy*, so that the public would clearly understand when and under what circumstances the Fed would use each rule.[7]

Step 2: The Fed Adopts a Nominal GDP Level Target

The second step would have the Fed switch to a target that aims to stabilize the growth path of total dollar spending in the economy. This approach, known as nominal GDP level targeting (NGDPLT), has several advantages over the Fed's current inflation target. First, NGDPLT stabilizes the growth of household and business incomes, since for every dollar spent there is a dollar earned. Consequently, by stabilizing total dollar spending, NGDPLT actually stabilizes total dollar

income growth. This is an invaluable feature during crisis periods, such as the current one, since it keeps dollar incomes in line with previous expectations of dollar income growth. To be clear, NGDPLT does not prevent the economy from getting poorer. It does, however, prevent secondary spillover effects that can arise from a sudden drop in household and business income, such as an inability to make mortgage payments and payrolls.

The second advantage of NGDPLT is that it makes up for past misses. That is, if total dollar spending were to fall short of the Fed's target, that shortage would be made up for in subsequent periods. If credible, this target would minimize the tendency for households and businesses to panic in a crisis, since NGDPLT creates expectations of stable dollar income growth. NGDPLT, in short, provides a beneficial makeup policy and has a calming effect on markets.[8]

This policy brief follows the suggestion of economist Lars Svennson that the Fed should target forecasts and calls for a forecast version of a nominal GDP target.[9] That is, the Fed should aim to guide the forecast of nominal GDP to its targeted growth path. Given these first two steps, the Fed's two-rule approach to monetary policy can be stated as follows:

Taylor rule: if $i_t > 0$, then

$$i_t = i_t^N + \lambda_1 NGDP_{t,t+h}^{Gap}.$$

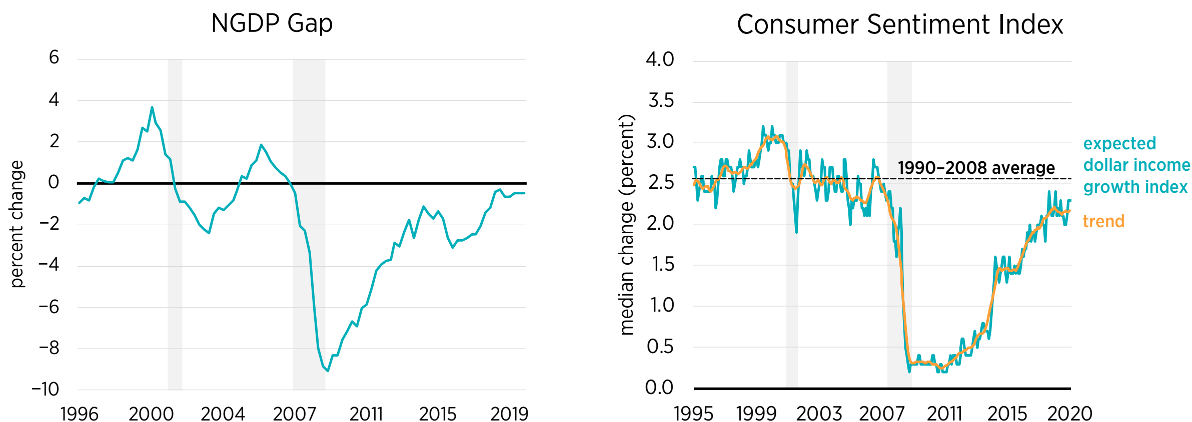
McCallum rule: if $i_t \leq 0$, then

$$\Delta \mathrm{b}_t = \Delta \mathrm{x}^* - \Delta \mathrm{v}_{t,t+h} - \lambda_1 NGDP_{t,t+h}^{Gap}.$$

Here, i_t^N is the neutral interest rate, $NGDP_{t,t+h}^{Gap}$ is the percentage gap between the forecasted and targeted growth path of nominal GDP at the $t+h$ forecast horizon, Δb_t is the growth rate of the monetary base, Δx^* is the targeted growth rate of nominal GDP, and $\Delta v_{t,t+h}$ is the forecasted growth rate of the monetary base's velocity. The first equation, the Taylor rule, says that if nominal GDP is expected to rise above its target, then the Fed should raise interest rates, and vice versa. It is only used when the overnight target interest rate is greater than 0 percent. The second equation, the McCallum rule, says that the Fed should grow the monetary base at a pace equal to the targeted growth rate of nominal GDP less the expected velocity growth rate less the size of the nominal GDP gap. That is, all else equal, if nominal GDP is expected to rise above its target, then the Fed should lower the growth rate of the monetary base, and vice versa. It only kicks in when interest rates are at 0 percent or less.

To implement these rules, I suggest two readily available nominal GDP gap measures. The first one (shown on the left in figure 1) is constructed using quarterly data from the Federal Reserve Bank of Philadelphia's "Survey of Professional Forecasters." It shows the percent difference between what forecasters thought nominal GDP would be in a particular quarter and what it actually turned

Figure 1. NGDP Gap Measures for the Policy Rules



Source: Author's calculations based on "Survey of Professional Forecasters" (database), Federal Reserve Bank of Philadelphia, accessed March 17, 2020, https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters; "Index of Consumer Sentiment" (dataset), Survey of Consumers, University of Michigan, accessed March 17, 2020, http://www.sca.isr.umich.edu/charts.html.

out to be.[10] Real-time data versions of this measure using vintage data show it to be reliable even during turning points in the economy.[11] However, it is available only on a quarterly frequency. If the Fed were to desire a monthly measure, then it could use the University of Michigan's Consumer Sentiment Survey, which measures households' expected dollar income growth over the next year (shown on the right in figure 1). The difference between this series and the 1990–2008 average could be used at the nominal GDP gap. Both series have similar movements and capture the spirit of the nominal GDP gap idea.[12]

Step 3: The Fed Gets a Standing Fiscal Facility

The final part of the operating framework would establish a standing fiscal facility for the Fed to use when doing helicopter drops. Specifically, the "Stella Fiscal Facility" (SFF) is proposed—named after Peter Stella's suggestion to institutionalize the US Treasury's Supplementary Financing Program that was used in 2008 by the Fed to help manage its balance sheet.[13] Stella proposes the SFF as way for the Fed to shrink its large balance sheet, but it can also be used to help facilitate the Fed's helicopter drops. Its use would be triggered when interest rates hit 0 percent and would be regulated by the McCallum rule, as outlined earlier. Also, I propose that its use should be approved by the Treasury secretary every time it is used. This would make the Fed's use of helicopters drops, a form of fiscal policy, more accountable to the public.

Operationally, the SFF would create Treasury securities that would be deposited at the Fed. This increase in Fed assets could then be matched by an increase in Fed liabilities that are issued to the public via the McCallum-rule-governed helicopter drops. Since these special Treasury securities would be held only by the Fed, they would not count toward the debt ceiling.[14] The funds would

be dispersed to households via the existing IRS tax refund infrastructure.[15] The direct transfer of money to households at 0 percent is a useful feature, since traditional monetary policy transmission through the financial system often breaks down or gets clogged in a severe recession. Helicopters drops, in short, cut out the middleman of monetary policy when it is most expedient to do so.[16]

ADVANTAGES OF THIS OPERATING FRAMEWORK

This proposal has many advantages over the current operating framework and should be seriously considered by Congress and the White House. First, as noted earlier, it is robust in positive and negative interest rate environments. No matter what happens to interest rates, the Fed can still provide meaningful countercyclical monetary policy. Second, this operating framework reduces the likelihood of recessions because it provides powerful forward guidance through a nominal GDP level target. Specifically, if households and firms believe that the Fed will always correct past misses in its targeted nominal GDP growth path, then they have less incentive to drastically change their spending in the first place. Third, the SFF gives NGDPLT the full backing of the government's consolidated balance sheet and creates credibility for the Fed's actions. Fourth, in severe economic downturns this approach cuts out the middleman, and money can therefore be sent directly to households. Finally, the operating framework as outlined earlier would be implemented in a rules-based approach that includes the sign-off of the Treasury secretary when the SFF is tapped. This makes the Fed more predictable, systematic, and accountable to the public.

To be clear, this proposal is a radical departure from the current operating framework and would require congressional approval. Compared to the status quo, though, this approach is a bargain. For if no changes are made to the Fed's operating framework, the Fed is likely to be ineffective in the current and future recessions and thereby force the use of ad hoc fiscal policy. The proposal outlined here provides a way to employ fiscal policy in an effective and nimble manner while keeping the Fed as the main countercyclical government agency.

CONCLUSION

This brief outlines a much-needed overhaul of the Fed's operating framework. First, the Fed should adopt a two-rule approach, so that it can handle both positive- and negative-interest-rate environments. Second, the Fed should implement NGDPLT, so that dollar income growth can be stabilized. Finally, the Fed's operating framework needs the enhanced credibility and power that comes with granting the Fed limited access to a standing fiscal facility.

This brief also proposes how to accomplish these goals and encourage the Fed to act in a systematic, rules-based, and accountable manner. This proposal is also timely, given the severity of the COVID-19 shock to the US economy and the growing calls by many in Congress for direct cash

transfers to households. Such programs need to be conditional and tied to specific goals. This proposal provides a way to do direct cash transfers in a systematic and rules-based way.

The coming recession probably will turn out to be one of the sharpest downturns on record. The Fed is not equipped to handle this crisis in its current state. Hopefully, this policy brief will encourage discussion on these shortcomings and impress upon policymakers the need to upgrade the Fed's operating framework.

ABOUT THE AUTHOR

David Beckworth is the director of the Program on Monetary Policy at the Mercatus Center at George Mason University and a former international economist at the US Department of the Treasury. He is the author of *Boom and Bust Banking: The Causes and Cures of the Great Recession* and formerly taught at Western Kentucky University. His research focuses on monetary policy, and his work has been cited by the *Wall Street Journal*, the *Financial Times*, the *New York Times*, *Bloomberg Businessweek*, and the *Economist*. He has advised congressional staffers on monetary policy and has written for *Barron's*, *Investor's Business Daily*, the *New Republic*, the *Atlantic*, and *National Review*.

NOTES

1. Christopher Condon and Jeff Kearns, "Economists Rush to Quantify Recession with Wildly Varying Forecasts," *Bloomberg*, March 17, 2020.
2. Ezra Klein, "'This Feels Much Worse Than 2008': Obama's Chief Economist on Coronavirus's Economic Threat," *Vox*, March 13, 2020.
3. Geoff Earle and Emily Goodin, "BREAKING NEWS: White House Is Considering Cash Payments to U.S. Workers, As Mitt Romney Gets behind Plan to Give $1,000 to Every American EACH MONTH during the Coronavirus Crisis," *Daily Mail*, March 16, 2020.
4. Interest rates could go also go negative, but not much, because of the effective lower bound (ELB). This is the point at which cash becomes more valuable to hold than bonds. Money earns a zero percent return. If interest rates go slightly negative at the ELB and are low enough compensate for the storage costs of holding cash, then cash will be held instead of bonds. At that point, interest rates will stop falling and the ELB binds.
5. Examples include Joseph Gaganon, "What Have We Learned about Central Bank Balance Sheets and Monetary Policy?," *Cato Journal* 39, no. 2 (2019): 407–17; Elga Bartsch et al., "Dealing with the Next Downturn: From Unconventional Monetary Policy to Unprecedented Policy Coordination" (SUERF Policy Note No. 105, Société Universitaire Européenne de Recherches Financières, Vienna, October 2019); and David Beckworth, "An Operating Framework for the 21st Century," *Cato Journal* (forthcoming 2020).
6. This proposal is based off of Beckworth, "An Operating Framework."
7. The McCallum rule, unlike the Taylor rule, could actually be used for both positive- and negative-interest-rate environments. It also could be used for regular open market operations that do not require helicopter drops. The approach outlined in this policy brief could be amended to recognize these facts, but it's stated as is since most central banks use interest rates as their preferred operating instrument.
8. See David Beckworth, *Facts, Fears, and Functionality of NGDP Level Targeting: A Guide to a Popular Framework for Monetary Policy* (Arlington, VA: Mercatus Center at George Mason University, 2019); and Scott Sumner, "The Case for

Nominal GDP Targeting" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, October 2012) for more on NGDPLT.

9. Lars E. O. Svensson, "Inflation Forecast Targeting: Implementing and Monitoring Inflation Targets," *American Economic Review* 41, no. 6 (1997): 1111–46.

10. Technically, this is not a forward-looking forecast gap measure, but a contemporaneous one. Still, it could be used for the nominal GDP gap measure, and if desired, one could turn it into a forward-looking forecast gap using a simple forecasting model.

11. David Beckworth, "The Stance of Monetary Policy: The NGDP Gap" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, forthcoming 2020).

12. Fed officials could also use a nominal GDP forecast created by nominal GDP futures contracts, as suggested by Scott Sumner, "Using Future Instrument Prices to Target Nominal Income," Bulletin of Economic Research 41, no. 2 (1989): 157–62; and Scott Sumner, "A Market-Driven Nominal GDP Targeting Regime" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2013).

13. Peter Stella, "A Short Law to Enhance the Efficiency and Stability of the US Financial System" (unpublished manuscript, February 2020), PDF file.

14. More precisely, from a consolidated government balance sheet perspective, the Treasury securities net out and render the helicopters drops a net liability to the government. The SFF, therefore, only helps preserve the Fed's balance sheet position so that it can easily do helicopter drops.

15. The SFF is similar to proposals by Ben Bernanke, "What Tools Does the Fed Have Left? Part 3: Helicopter Money," *Ben Bernanke's Blog*, Brookings Institution, April 11, 2016; Gaganon, "What Have We Learned"; and Bartsch et al., "Dealing with the Next Downturn," who also call for granting the Fed a standing fiscal facility for use in deep recessions. The SFF proposed here, however, is unique, since its use would be tied explicitly to the McCallum rule that only kicks in once interest rates hit zero percent. This rule satisfies the conditions of Alan J. Auerbach and Maurice Obstfeldt, "The Case for Open-Market Purchases in a Liquidity Trap," *American Economic Review* 95, no. 1 (2005): 110–37; Michael Woodford, "Methods of Policy Accommodation at the Interest-Rate Lower Bound," in *The Changing Policy Landscape* (Kansas City, MO: Federal Reserve Bank of Kansas City, 2012), 185–288; and Willem H. Buiter, "The Simple Analytics of Helicopter Money: Why It Works – Always," *Economics* 8, no. 28 (2014): 1–51, which show for monetary base injections to matter at the ELB the public must expect the injections to be permanent and greater than base money demand growth. The McCallum rule satisfies these conditions since it has a nominal GDP level target embedded in it.

16. See Mark Blyth and Eric Lonergan, "Print Less but Transfer More: Why Central Banks Should Give Money Directly to the People," *Foreign Affairs* 93, no. 5 (2014): 98–104, 106–9; and Frances Coppola, *The Case For People's Quantitative Easing* (Cambridge: Polity Press, 2019) for more on helicopter drops.