

# An Alternative Operating Model *for the Fed*

BY MATT SEKERKE AND STEVE H. HANKE

*A new view of how  
money should work.*

**I**n the previous issue of *The International Economy*, Treasury Secretary Scott Bessent presented a wide-ranging critique of the Federal Reserve's monetary policy since the global financial crisis. Secretary Bessent's article laments the expansion of the Fed's balance sheet, its role in supervising the largest U.S. banks, and its culpability in the post-GFC explosion of economic inequality.

We share Secretary Bessent's dissatisfaction with the state of monetary policy. Indeed, the manifest unsustainability of the Fed's current operating model was the primary motivation behind our recent book *Making Money Work: How to Rewrite the Rules of Our Financial System* (Wiley, 2025). Here, we pick up the gauntlet thrown down by Secretary Bessent and outline our vision for a new Federal Reserve operating model.

## RETHINKING THE FORM AND CONTENT OF MONETARY POLICY

Monetary policy can be understood as achieving policy goals by establishing control over a target variable. Policy implementation is achieved with the aid of instruments which have a strong economic linkage to the target variable.

Table 1 compares the goals, targets, and instruments of post-GFC Fed monetary policy to those of our proposed operating model. The Fed has a well-known dual mandate to control inflation and maintain high levels of



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employment. Since the 1980s, the Fed has targeted short-term interest rates to achieve its goals. The Fed previously controlled short-term interest rates by changing the supply of bank reserves. Since the GFC, however, the Fed has paid interest on reserves and transacted heavily in repo markets to set short-term rates. The Fed has also used large-scale asset purchases (“quantitative easing”) to influence economic conditions, primarily through long-term interest rates.

In *Making Money Work*, we recommend that the Fed discard its interest rate targets and implementation strategy in favor of a regime that targets a Divisia broad money aggregate. Its most powerful instrument for controlling broad money is its role in bank supervision, rather than its balance sheet. The Fed can pursue its statutory goals effectively under this alternative regime. In addition, we propose that the Fed and the Treasury cooperate to monitor the neutrality of monetary outcomes (in a sense we explain further below) to foster accountability and transparency.

#### TARGETING BROAD MONEY

Monetarism and targets for monetary aggregates acquired a bad name at the Federal Reserve during the chairmanship of Paul Volcker.

Volcker’s monetarism missed the mark in three respects. First, the Fed targeted a monetary aggregate that was too narrow. Nonbank money holdings appeared to shrink as firms and households shifted their balances from bank deposits to better-remunerated substitutes like com-

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mercial paper, repurchase agreements, and money-market funds. A broader aggregate would recognize these actions as reallocation within a portfolio of money holdings, rather than a reduction in the demand for money.

Second, the Fed aggregated the public’s money balances by simply adding them up, without regard for their

**Table 1 Comparison of Current and Proposed Monetary Policy Frameworks**

	Post-GFC Fed Policy	Sekerke-Hanke Proposal
<b>Goals</b>	Price stability Growth at potential	Price stability Growth at potential Monetary neutrality
<b>Targets</b>	Short-term interest rates Long-term interest rates	Divisia broad money
<b>Instruments</b>	Interest on reserves Repo facilities Quantitative easing	Bank capital Regulatory risk weights

relative price. In an era with interest rates reaching 20 percent, the difference between a money balance paying 12 percent and one rewarded with the occasional toaster was material. A better aggregation methodology, such as Divisia, would account for the differences in user cost for different forms of money.

Third, the Fed tried to control its target aggregate by adjusting the quantity of bank reserves. This instrument was not fit for that purpose. We suggest better instruments in the following section of the article.

Drawing on the lessons learned from the Volcker era, we propose targeting a Divisia index of broad money. The “broad” quality of the index means that it accounts for contributions from all the forms of money and money substitutes in regular use among the nonbank public. And a “Divisia” index accounts for differences in user cost across forms of money. The more interest one gives up by holding a monetary balance, the more monetary services the balance is deemed to provide.

Table 2 shows the forms of money that are included in the Divisia M2-ALL, M3, and M4M indices published by the Center for Financial Stability. The table also indicates where each form of money originates in the economy. It is immediately evident that the banking system is responsible for producing most of the components of broad money.

Improving the measurement of the money supply makes the basic monetarist idea of matching the supply and demand for money a more tractable goal. And indeed, there is evidence that the demand for Divisia broad money is more stable and forecastable than the demand for Volcker-style aggregates. Divisia broad money demand is a target the Fed can hit.

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We believe Divisia broad money is a better target than interest rates for monetary policy for two main reasons. First, as Secretary Bessent points out, interest rate policy plays havoc with asset prices, leading to misallocated capital and unpredictable effects on consumption. Second, interest rate policy targets an unobservable and somewhat dubious equilibrium rate known as  $r^*$  or  $(r^*)$ , leaving wide scope for policy errors.

### HOW TO CONTROL BROAD MONEY

So how can the Fed target the growth rate of broad money? The bulk of the answer, based on the composition of Divisia broad money, depends on what constrains the banking system's ability to produce deposit money. Demand deposits are produced when banks make loans. Deposit balances migrate to other forms of money, but they eventually return to be destroyed when loan principal is repaid. A broad money-targeting Fed will need to model this whole process, but the prime movement in the sequence is new lending.

Many factors besides interest rates constrain the banking system's ability to make new loans: the universe of bankable projects, the distribution of borrower equity, and bank liquidity situations all contribute to delimiting the banking system's opportunity set. Since the GFC, however, the most important constraint on bank lending has been the supply of regulatory capital.

Since the late 1980s, the United States has worked with other G20 nations through the Basel Committee on Banking Supervision to formulate internationally binding rules for determining a bank's capital adequacy. BCBS rules assign risk weights to different kinds of bank exposures, as well as an overall minimum level of capital a bank must hold given its weighted risks. Since most internationally active banks combine commercial banking business with a trading business focused on capital markets, the BCBS sets rules for both kinds of activities. The latest iteration of the BCBS rules, known as Basel III, adds considerable risk weight to capital markets activities.

Following the GFC, many banks subject to the BCBS rules were undercapitalized (for obvious

reasons) and therefore pulled back on their lending activity. Broad money growth quickly collapsed, and would have deteriorated further in the absence of quantitative easing by the Fed. Then, from roughly 2011 to 2018, the Fed's Comprehensive Capital Analysis and Review framework restricted banks' ability to return capital to shareholders. Banking system capital accumulated, allowing the banking system to expand its lending and return to its central role in producing the broad money supply.

During the 2011–2018 period, Divisia broad money grew at a steady pace of about 5 percent per annum. Inflation remained below the Fed's target, and the U.S. economy grew at a steady pace. The period was not an unalloyed success, however. Too much new lending was destined for the real estate sector, and banks chafed at the CCAR framework.

Nevertheless, the episode shows that bank capital can be a powerful instrument for controlling the growth rate of broad money. This means that the Fed's primary contribution to monetary conditions can come from its bank regulatory role, rather than the size of its balance sheet or the supply of bank reserves. So long as bank capital remains the binding constraint on bank loan growth, broad money growth will be closely tied to the rate at which bank capital accumulates. Thus, bank regulation can be a powerful instrument of monetary policy.

**Table 2: Selected Divisia Monetary Aggregates**

	M2-ALL	M3	M4M	Source
Cash	X	X	X	Government
Demand Deposits	X	X	X	Banks
Other Liquid Deposits	X	X	X	Banks
Savings Deposits	X	X	X	Banks
Money Market Deposit Accounts	X	X	X	Banks
Retail MMFs	X	X	X	Nonbanks
Small Time Deposits	X	X	X	Banks
Institutional MMFs	X	X	X	Nonbanks
Large Time Deposits		X	X	Banks
Repurchase Agreements		X	X	Government
Commercial Paper			X	Nonbanks

### THE GOAL OF NEUTRALITY

However, we also care about the composition of bank loan growth. Bank capital rules favor money creation for certain borrowers and certain sectors of the economy. The BCBS rules have historically favored households over firms, and real estate projects over other business activities. Injections of money into favored sectors are not quickly dissipated and can have long-lasting effects on the character of economic activity.

Secretary Bessent has correctly noticed that uneven money production can exacerbate economic inequality. It is eminently plausible that differences in money supply and demand across sectors of the economy and strata of the incomes distribution can lead to heterogeneous growth and inflation outcomes. The instrumentation of a quantity-targeting Fed should include sector-level monetary aggregates which would allow for granular monitoring of monetary policy's distributional consequences.

Sector-level aggregates would also help to get monetary and fiscal policy on the same page. Differences in net taxation and government bond holdings across economic sectors can affect the distribution of money balances as

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much as differences in lending activity. Publication of granular monetary and fiscal data would foster transparency and accountability in both domains of policymaking.

As Secretary Bessent continues to think about how to rewrite the rules of the financial system, we would encourage him to consult *Making Money Work* for further details. ◆