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A Dual Mandate for the Federal Reserve

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The Federal Reserve currently has two legislated goals: price stability and full employment. The original Federal Reserve Act of 1913 contained no macroeconomic goals. Rather it instructed the Fed to prevent financial panics and bank runs by providing loans to the banking system. In the aftermath of the Great Depression, the Employment Act of 1946 required the Fed to pursue "conditions under which there will be afforded useful employment opportunities . . . for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power." By the 1970s the term maximum employment was understood to mean not zero percent unemployment, but the level of unemployment that arises in a healthy economy as employers and employees seek good matches. In 1978, the Full Employment and Balanced Growth Act required the federal government to "promote full employment . . . and reasonable price stability."[1]

Although this dual mandate exists, Congress is now debating whether the Federal Reserve should assign primacy to fighting inflation. The Price Stability Act, introduced in 1999, sets price stability as the "primary and overriding goal" of monetary policy; it requires the Federal Reserve to establish an explicit numerical goal for inflation and to specify a time frame for achieving this goal. Although the bill did not pass, momentum in favor of inflation targeting is growing, and similar legislation will be introduced again.

Although some might argue that in recent years the Fed has focused solely on inflation, evidence from Taylor's rule, statements of Federal Reserve governors, the behavior of the federal funds futures market, and recent monetary policy history indicates that high employment as well as price stability have been goals of the Fed. The Federal Reserve can affect inflation and unemployment through its manipulation of the federal funds rate (the rate banks charge each other on one-day loans). The Fed sets a target value for the funds rate and then adjusts the amount of funds (reserves) in the banking system to cause the funds rate to move toward the

target value. When the funds rate increases, longer-term interest rates tend to increase and the dollar tends to appreciate. The increase in longer-term rates reduces spending on interest-sensitive items such as houses and automobiles; the appreciation of the dollar reduces spending on net exports. As spending declines, employment, output, and inflation decline as well. Thus, when the Fed seeks to lower inflation, it raises the funds rate target, and when it seeks to lower unemployment, it decreases the rate target.

In recent years, during which the Fed has adjusted the funds rate to affect both inflation and unemployment, macroeconomic performance has been excellent. Both unemployment and inflation have been low. Since both high economic growth and low inflation benefit the stock market, recent macroeconomic performance has contributed to the 180 percent increase in the Dow Jones Industrial Average between January 1995 and August 1999.

In spite of the economy's good performance under the dual mandate of the Full Employment and Balanced Growth Act, research on inflation targeting has convinced many analysts that the mandate needs to be changed. The case for inflation targeting rests on several arguments (Bernanke, Laubach, Mishkin, and Posen 1999). First, monetary policy cannot affect real variables in the long run; it can affect only inflation. Second, monetary policy cannot be used effectively to moderate short-run economic fluctuations because it has an inflationary bias. Third, even moderate rates of inflation are harmful to economic growth. Fourth, a nominal anchor for monetary policy is necessary, and inflation targeting provides such an anchor.

The history of monetary policy and the economy from 1960 to 1999 contradicts these arguments. Recent events show that the natural rate of unemployment is affected by disinflationary policy and duration of unemployment benefits, implying that monetary policy can affect long-run real variables. In 1979 the Fed did engineer a deflation and it has since kept inflation low sometimes through preemptive moves and without adopting binding rules. The costs of anticipated inflation have been minuscule, and the costs of unanticipated inflation have been estimated to be quite small. Finally, the Fed has kept inflation low without using an explicit nominal anchor such as a target for the exchange rate or inflation.

In addition to the rebuttal of the case for inflation targeting, there are many reasons why the Fed's mandate should continue to emphasize full employment. First, the macroeconomic conditions that have prevailed while the Fed has been pursuing both full employment and price stability have been wonderful. Unemployment and inflation are near 30-year lows. By contrast, seven of the eleven countries under the jurisdiction of the European Central Bank, which has adopted inflation targeting, have unemployment rates exceeding 10 percent. With the U.S. economy faring so well under the current monetary policy regime, it seems unwise to switch to a regime that has not produced similar results in other countries.

Second, unemployment imposes heavy costs on individuals and the economy. Because the Fed lowers inflation primarily through lowering aggregate demand and employment, the more it seeks to stabilize inflation, the more it will destabilize employment in the short run. Dornbusch,

Fischer, and Startz (1998) calculate that the fact that unemployment in 1992 was 2 percentage points above the natural rate implies that gross domestic product was 4 percent less than it otherwise would have been (in 1999, 4 percent of GDP was equal to about $350 billion). In addition, unemployed individuals suffer heavy losses. As Thorbecke (1997, forthcoming) shows, the individuals who bear the brunt of disinflationary policy tend to be poorer and lower on the occupational ladder and are consequently less able to weather the difficulties caused by losing a job. They suffer not only monetarily but also in terms of dignity, self-esteem, health, and forgone training.

A third reason the Fed's mandate should include full employment is that central bankers tend to be inflation-averse and need to be prodded to take conditions other than inflation into account. Monetary theory teaches that in the long run inflation is a monetary phenomenon. Monetary policymakers can take such a long-run perspective because they are not vulnerable to short-term electoral cycles; they do so also because they believe that they cannot smooth out transitory shocks anyway. Telling a central banker to focus on controlling inflation is like telling a defensive lineman to focus on tackling the quarterback. He will do that without advice. What is necessary is to tell him to watch also for a screen pass or a draw play. In the same way, it is necessary to tell a central banker to consider also unemployment and real economic activity.

Some might argue that Alan Greenspan has been successful because he focuses on inflation and that this is the approach that should be encoded in legislation. However, in the hands of someone without Greenspan's deep grasp of the economy, the requirement that low inflation be the overriding goal of monetary policy could have bad outcomes. For instance, in 1996, when most economists thought that unemployment was below the natural rate, a central banker mandated to achieve only price stability could easily have prevented unemployment from falling further. He or she could have argued that unemployment was at its maximum sustainable level, and most economists would have agreed. However, if the Fed chairman is mandated to give equal weight to employment gains, he or she might be emboldened at strategic times to take risks and let unemployment fall. The results after 1996 were that unemployment fell more than a percentage point and employment increased by more than 7 million workers. The benefits of this strong labor market have accrued to low-skilled workers, minorities, and single mothers without triggering inflation. It would have been tragic if these gains to less-advantaged individuals had been lost because the Fed kept unemployment higher to fight a nonexistent inflation.[2]

A fourth reason for not pursing only price stability is that the price level would not be free to increase in response to shocks. As Friedman and Kuttner (1996) explain, following a negative supply shock, real wages (nominal wages relative to the price level) have to be allowed to fall to avoid large increases in unemployment. Because in the United States it is hard to cut workers' nominal wages, an increase in the price level is necessary to cut real wages and minimize employment losses. If the Fed is pursuing price stability exclusively, the price level would not be allowed to rise, and an adverse supply shock would multiply unemployment beyond the increase following the initial shock.

The current monetary policy regime, which emphasizes both full employment and price stability, is obviously working.

The dual mandate has allowed the Fed to focus on one or the other goal as conditions demand and to balance the effects of policy decisions. Changing this approach, which has contributed to outstanding macroeconomic conditions, seems unwise. Instead, officials in inflation-targeting countries should consider following the U.S. model and assign weight to unemployment as well as to inflation in formulating monetary policy.

Notes

1. This paragraph draws on the discussion by Judd and Rudebusch (1999). According to Blinder (1996), the Fed has a third legislated goal, "moderate long-term interest rates." However, since achieving price stability will almost surely produce low long-term rates, the Fed is viewed as having a dual mandate of pursuing full employment and stable prices.
2. The same might be said of 1983. Milton Friedman forcefully warned about inflation and demanded that money growth be reined in. The Fed ignored his warning. Inflation remained moderate, unemployment fell rapidly, and the U.S. economy experienced a 92-month recovery.

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