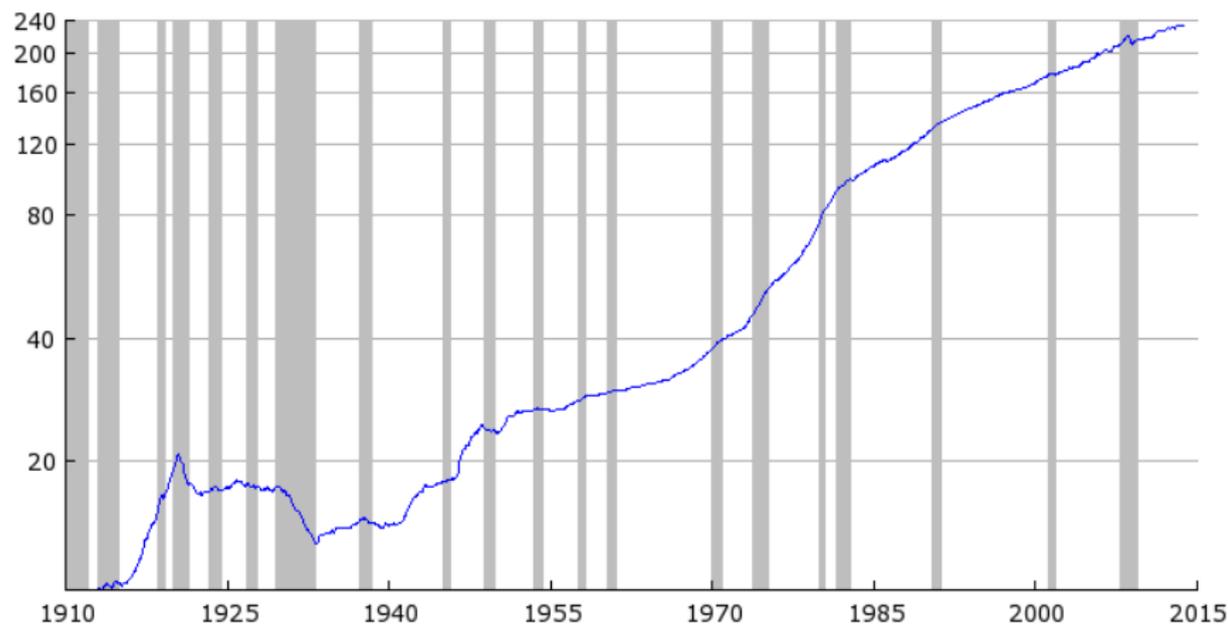


The Evolving Interpretation of the Mandate of the Federal Reserve

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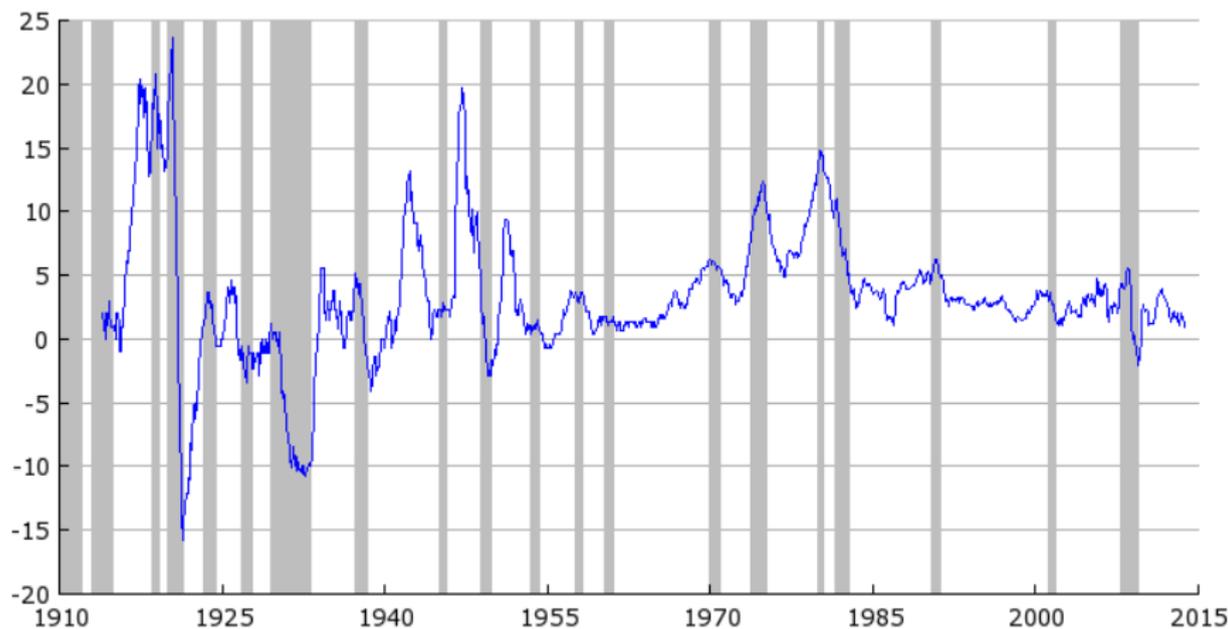
Philadelphia, December 6, 2013
The Philadelphia Fed Policy Forum
The History of Central Banking in the United States

Evaluating the Fed: The price level



CPI for all urban consumers: 1982-84=100

Evaluating the Fed: Inflation



CPI for all urban consumers: yoy percent change

100 years of the Fed: What have we learned?

- ▶ A well-functioning monetary system is a prerequisite for the greatness of any nation.
- ▶ Price stability is essential for a well-functioning monetary system.
- ▶ However, the Federal Reserve has been hampered by the lack of clarity in its mandate.
- ▶ At times during its history, the Fed's mandate has been interpreted too broadly, raising expectations that it could achieve multiple goals, beyond what any central bank can deliver.

An overburdened institution?

- ▶ At times, the Fed has overreached its goals.
- ▶ When a central bank attempts to accomplish tasks that it cannot achieve it invariably fails.
- ▶ A central bank can deliver price stability over time.
- ▶ A central bank can also temporarily deliver cheap credit to pursue other goals, compromising price stability.
- ▶ Lack of clarity in the Fed's mandate has repeatedly led it to lose sight of price stability.

In the beginning ...

“AN ACT To provide for the establishment of the Federal reserve banks, to furnish an elastic currency ...”

“Every Federal reserve bank shall have the power: ...
To establish ... rates of discount ... which shall be fixed with a
view to accommodating commerce and business.”

(Section 14, Federal Reserve Act, 1913)

1939: Widely diffused well-being

“The purpose of Federal Reserve functions, like that of Governmental functions in general, is the public good. Federal Reserve policy can not be adequately understood, therefore, merely in terms of how much the Federal Reserve authorities have the power to do and how much they have not the power to do. It must be understood in the light of its objective—which is to maintain monetary conditions favorable for an active and sound use of the country’s productive facilities, full employment, and a rate of consumption reflecting widely diffused well-being.”

(The Federal Reserve System: Its Purposes and Functions,
first edition, 1939)

1947: The sinews of war

“In time of war the duty of the Federal Reserve, as of everyone, is to support the country’s war effort. The Federal Reserve provides machinery for aiding the Government to finance the enormous expenditures necessitated by war”

“Prevention of inflation had to become secondary to providing the sinews of war.”

(*The Federal Reserve System: Its Purposes and Functions*, second edition, 1947)

1946: The Employment Act

“It is the continuing policy and responsibility of the Federal Government ... to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.”

(Section 2, Employment Act of 1946.)

1957: Price stability is essential

“The objective of the System is always the same—to promote monetary and credit conditions that will foster sustained economic growth together with stability in the value of the dollar. ... Price stability is essential to sustainable growth.”
(Investigation of the Financial Condition of the United States Hearing before the Committee of Finance, United States Senate, August 1957.)

1977: The Humphrey-Hawkins mandate

“The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

(Federal Reserve Act, Section 2A, 1977 amendment.)

Practicing Humphrey-Hawkins

- ▶ Focus on price stability as the operational primary objective to achieve long run growth and employment.
- ▶ Aim at economy's long run potential growth and employment.
- ▶ Avoid numerical targets for employment.
- ▶ Avoid activist pursuit of employment targets.

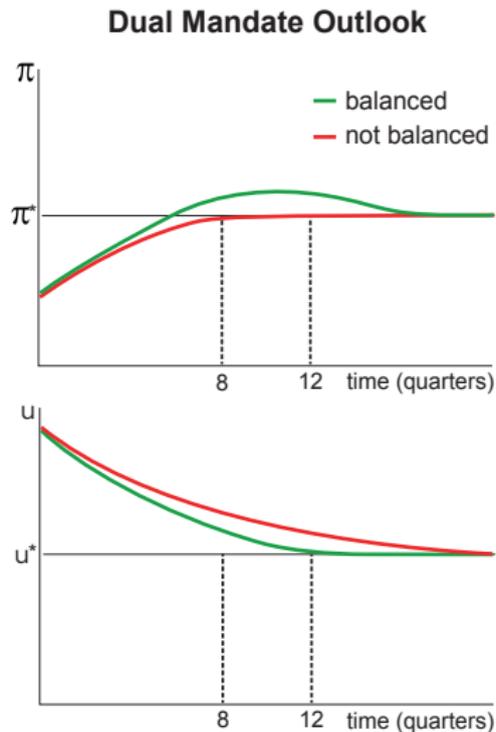
2012: A Reinterpretation

“Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability

...

[T]he Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored” (FOMC statement, December 2012.)

Price stability or a dual mandate: A conflict?



Kocherlakota (2013)

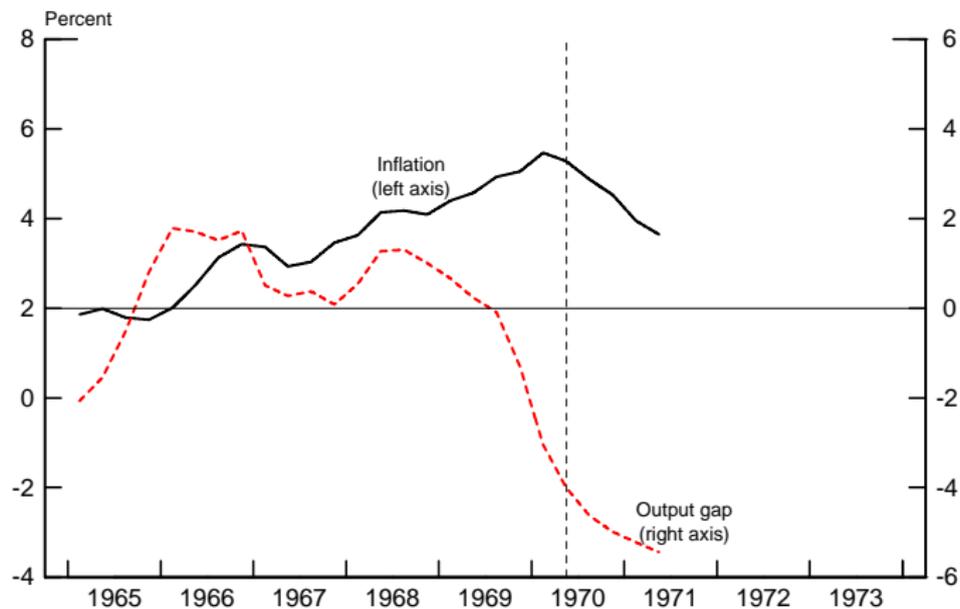
Price stability or a dual mandate: A conflict?

“I know that it is fashionable to talk about a ‘dual mandate’—that policy should be directed toward the two objectives of price stability and full employment. Fashionable or not, I find that mandate both operationally confusing and ultimately illusory: ... The Federal Reserve, after all, has only one basic instrument so far as economic management is concerned—managing the supply of money liquidity. Asked to do too much ... it will inevitably fall short. If in the process of trying it loses sight of its basic responsibility for price stability, a matter which is within its range of influence, then those other goals will be beyond reach.” (Volcker, 2013.)

What can go wrong? An example from 1970

- ▶ August 1970: FOMC unhappy with pace of recovery.
- ▶ Economy growing but unemployment remained high.
- ▶ Staff analysis suggested that with underutilized resources, inflation forecast would be in line with price stability.
- ▶ Output-gap-based “optimal policy” suggested easier monetary policy was needed to close the output gap faster, while inflation was on the right track.
- ▶ So the FOMC kept easing.

Inflation and output gap: August 1970



August 1970 FOMC: FRB staff analysis

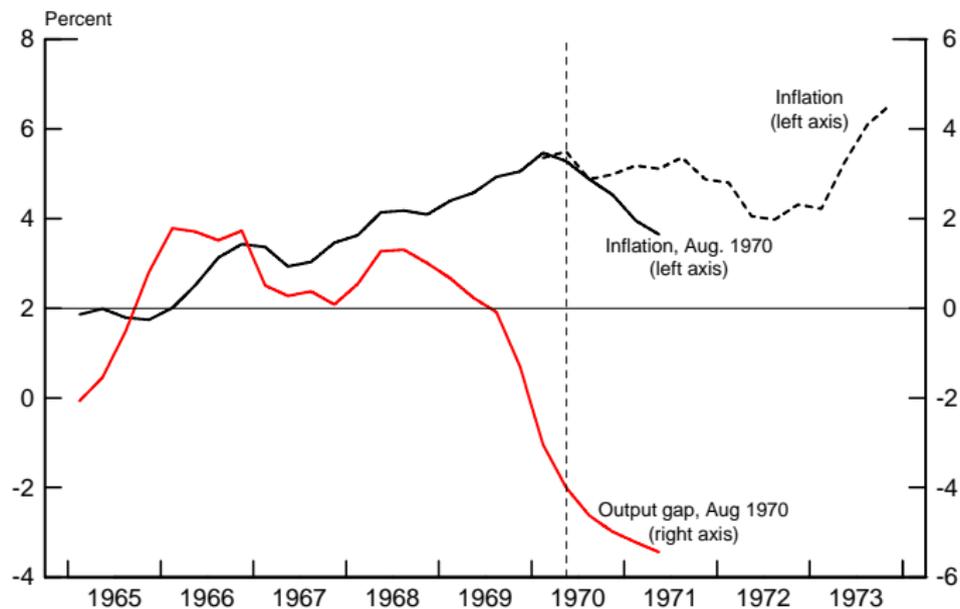
“Moreover, the upturn would be starting from a point where there is substantial underutilization of resources, as evidenced by a 5 percent unemployment rate and an operating rate in manufacturing at well under 80 per cent of capacity. In these circumstances, there is virtually no risk that economic recovery over the year ahead would add to the inflationary problem through the stimulation of excess—or even robust—demand in product or labor markets.”

Federal Open Market Committee, Memorandum of Discussion, August 1970, p. 19.

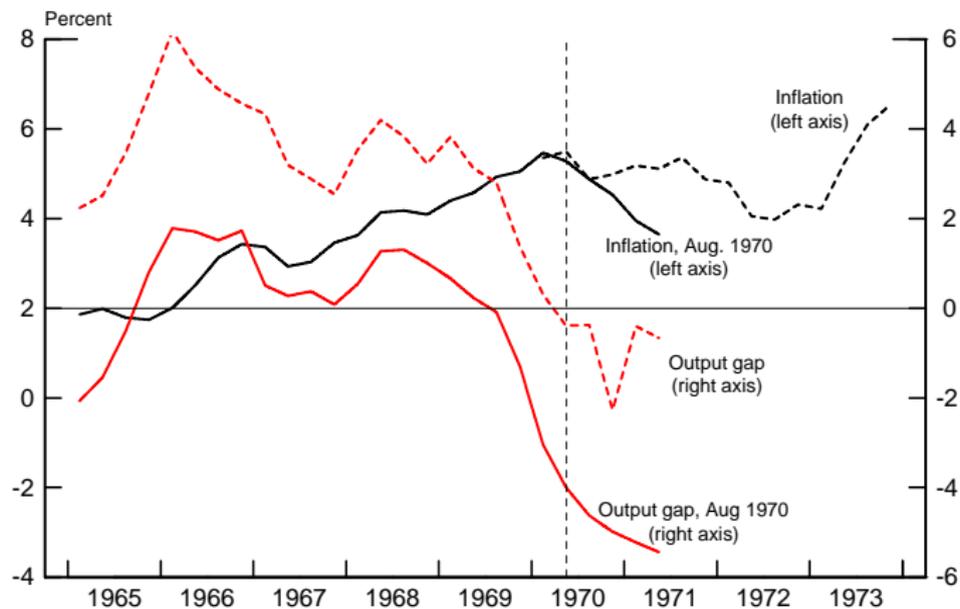
The FOMC meeting on August 18, 1970

"If those projections were realized, however, the gap between actual and potential real GNP would be between 5.5 and 6 per cent by the second quarter of 1971. In his judgment, that was not satisfactory as a goal of policy." (FOMC member commenting on FRB staff forecast)

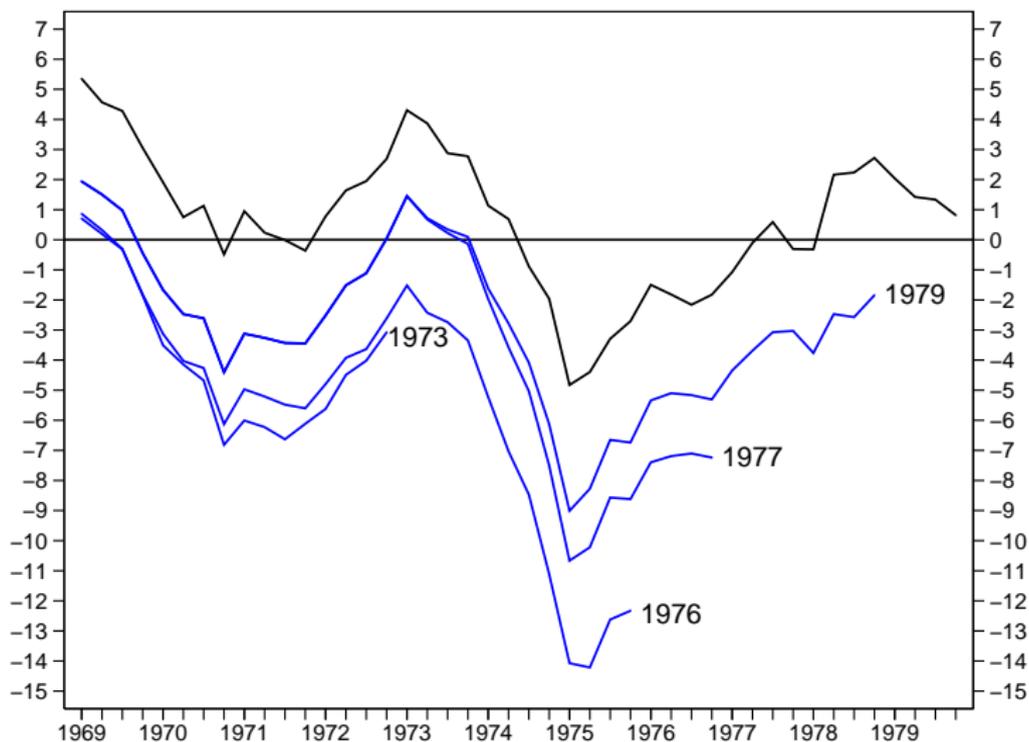
Inflation and output gap



Inflation and output gap



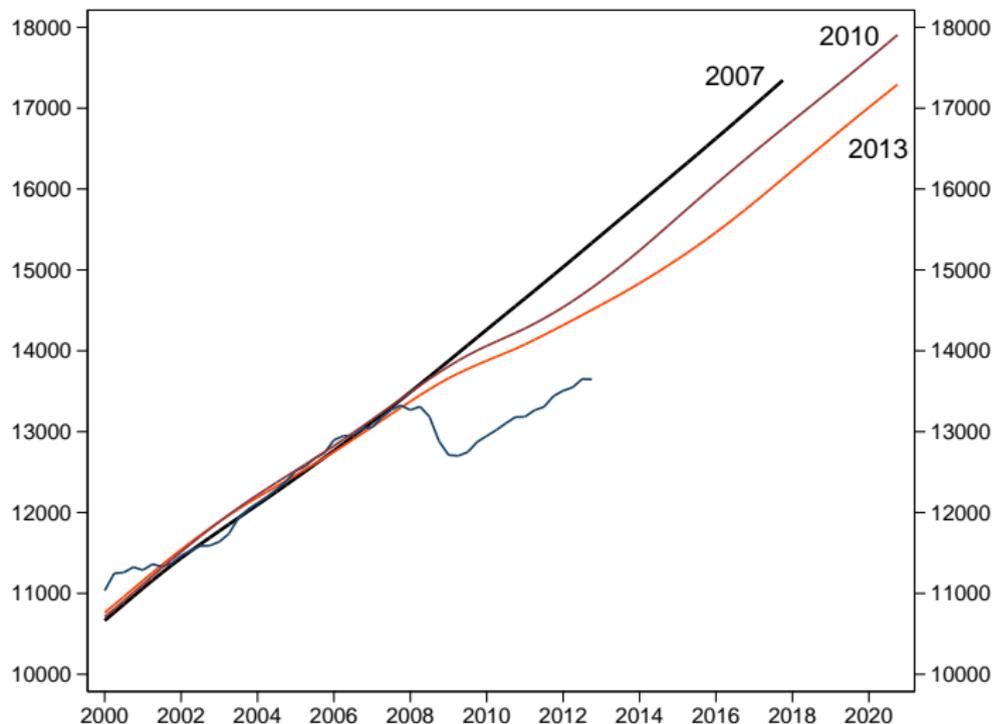
Output gap revisions: 1976, 1977, 1979 ...



Result of the 1970 experience

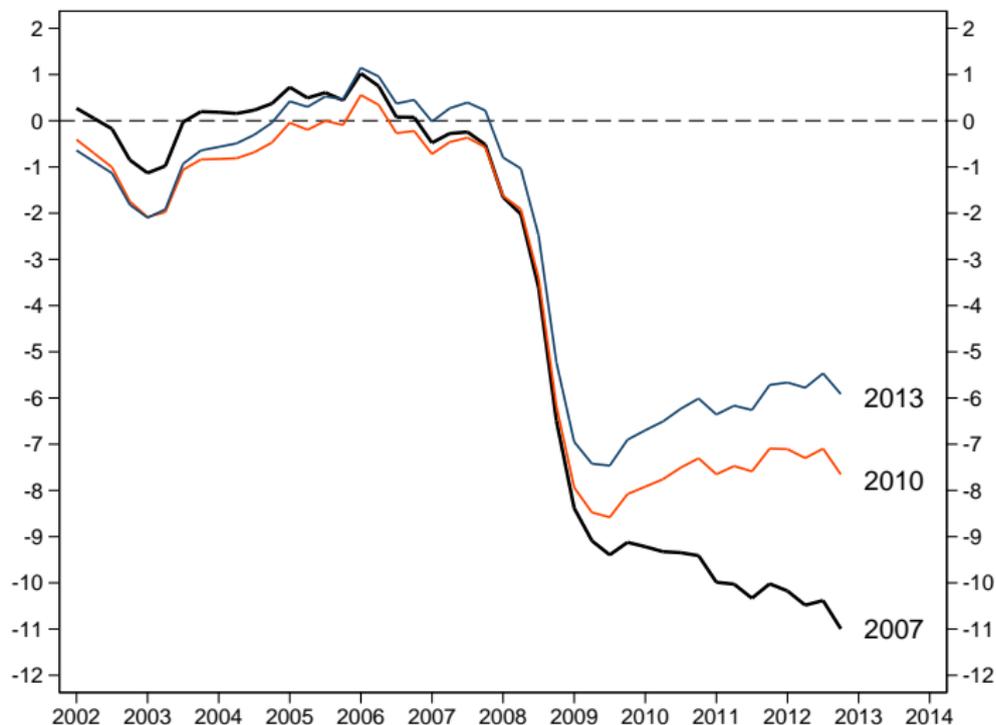
- ▶ Fed staff and FOMC thought they were following a balanced approach consistent with achieving full employment and price stability.
- ▶ Frustration with slow pace of recovery justified in their minds what turned out to be excessive policy easing.
- ▶ Measures of full employment proved exceedingly misleading, but this was not recognized until several years later.
- ▶ The easy money policy of 1970 morphed into the stagflation of the 1970s.

Have these uncertainties been resolved?



GDP and revisions of CBO potential GDP estimates.

Output gap estimates: 2007, 2010, 2013, ...



Based on alternative CBO potential GDP estimates.

Where do we stand today?

- ▶ The “full employment” mandate is invoked to justify the continuation of the unprecedented expansion of the balance sheet of the Federal Reserve, despite the continued improvement in the economy.
- ▶ Guided by a broader interpretation of its mandate, the Fed risks losing sight of price stability.
- ▶ Ideally, Congress should clarify the Fed’s primary objective to preserve price stability.
- ▶ Until then, the Fed should avoid the temptation to overreach.