The Need for a Price Stability Mandate

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The founding of the Federal Reserve was a good idea, but its performance during its first hundred years has been hampered by the lack of clarity of its mandate. At times its mandate was interpreted as requiring the pursuit of multiple targets resulting in the failure to safeguard price stability over time. This article reviews the evolution of the Federal Reserve's mandate and argues that Congress should clarify the primacy of price stability as the central bank's mandate to ensure that the Federal Reserve will better safeguard monetary stability going forward.

Was the Fed a Good Idea?

Was the Fed a good idea? In one word: "Yes!" This is perhaps the expected answer from someone who spent many years at the Federal Reserve. This one-word answer, however, reflects the more general belief that a well-functioning monetary system is a prerequisite for the greatness of any nation and that a central bank is necessary to safeguard monetary stability in a modern economy. Over the past century, the United States has evolved into the most powerful nation on earth, and the creation of the Federal Reserve 100 years ago has contributed to this achievement. Emergencies may arise where the

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very existence of a nation could be threatened in the absence of a central bank. During war, the ability of a nation's central bank to facilitate the financing of the war effort may become a matter of existential consequence. During crises central banks can play a critical stabilizing role.

While the creation of the Fed was a good idea, a qualifier is also appropriate: In two words, my answer is "Yes, but." In its history so far, the Federal Reserve has not always managed to avoid major errors. On the 100th anniversary of the Federal Reserve, it is appropriate to focus on what can be learned from the mistakes of the past to improve its performance going forward.

A central bank is necessary to ensure a well-functioning monetary system. But what exactly should a central bank aim to do? How broad should its mandate be? How can it best contribute to the functioning of our economy? Some envision a very broad mandate for the central bank and the discretionary power to seek numerous objectives all at once. Others suggest a more limited role, guided by systematic rules that avoid discretionary actions. Discretion should never be ruled out completely. Crises and emergencies may require actions that deviate from systematic rules. Not all circumstances can be foreseen and neatly captured in systematic rules ahead of time. The relevant questions are: What defines the systematic behavior of the central bank? How clear are its objectives under normal circumstances? and How limited is its discretion during crises?

Despite the best efforts of its dedicated staff and leadership, the Federal Reserve did not avoid serious errors. Why were these errors committed? What was the central bank trying to achieve? Did the Federal Reserve deviate from attempting to attain its mandate and if so how? In my view, an important part of the answer is that the Federal Reserve has been hampered by the lack of clarity in its mandate. At times, its mandate was interpreted overly broadly, overburdening the central bank beyond what any central bank can reasonably be expected to deliver. At times, this has led the Federal Reserve to try to achieve too many things at once and lose sight of price stability, the one objective that a central bank can and should deliver over time.

While price stability is essential for a well-functioning monetary system, the mandate of the Federal Reserve has never clearly specified that it should treat price stability as its overriding objective. This can be corrected. What is required is an Act of Congress to make price stability the primary objective of the Federal Reserve.

An Evolving Mandate

When the Federal Reserve was founded in 1913, the Federal Reserve Act made no mention of price stability and its mandate was rather diffuse. The preamble of the Federal Reserve Act called for the establishment of the Federal Reserve "to furnish an elastic currency." Section 14 of the Act came closest to specifying a policy objective:

> 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].

As the Federal Reserve was founded in the environment of the gold standard, which was thought to safeguard price stability over time, it could be argued that in 1913 it was not necessary to explicitly state that price stability should be the mandate of the institution. The leadership and the staff of the Federal Reserve made efforts toward a more concrete interpretation of the mandate, but the lack of clarity hampered the institution.

In 1939, in the first edition of the Federal Reserve's publication *Purposes and Functions*, the Board of Governors tried to explain its role as follows:

> The purpose of Federal Reserve functions, like that of Governmental functions in general, is the public good. Federal Reserve policy cannot 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 [Board of Governors of the Federal Reserve System 1939].

Widely diffused well-being sounds wonderful, like motherhood and apple pie! But of course, this is not a statement of what the Federal Reserve could achieve, and it's not a statement about what the Federal Reserve could be held accountable to. It is evidence that without clear guidance, the Federal Reserve was trying to achieve things beyond its control, with no systematic guide. This was reflected in the outcomes. The 1930s was arguably the worst decade in the history of the institution. Remarkably, after episodes of rather violent inflation and deflation experienced during the first 25 years of the Federal Reserve, no mention of price stability as an objective can be found in this description.

Things changed for the better during the 1950s. The Federal Reserve managed to preserve price stability and support economic growth better during this period. This was not an accident. The 1950s was a period during which the Federal Reserve adopted a more useful and appropriate interpretation of its objectives. An example appears in a response provided by the Board to a hearing of the Senate Committee of Finance in August 1957.

> 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 [U.S. Senate 1957].

Understanding that "price stability is essential to sustainable growth" was key to the success of the 1950s. Unfortunately, since the primacy of price stability was not mandated by Congress, no assurance could be provided that this interpretation would persist. Indeed, price stability was not properly defended and things changed for the worse in the late 1960s and the 1970s.

In 1977, the Congress amended the Federal Reserve Act in an effort to improve monetary stability.

> 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].

The 1977 amendment defined maximum employment and stable prices as the "dual mandate" of the Federal Reserve (with the understanding that long-term interest rates would remain moderate if price stability was achieved). Unfortunately, once again the Congress failed to provide clarity regarding the primacy of price stability. The lack of clarity meant that the Federal Reserve retained considerable discretion in interpreting its mandate. The Federal Reserve remained at risk of shifting from the interpretation that resulted in relatively good outcomes in the 1950s to the interpretation that led it to the disastrous outcomes of the 1930s.

Following Paul Volcker's appointment as chairman in 1979, and the successful disinflation he engineered early in his tenure, the United States experienced a long period of reasonable price stability and growth. Was that made possible by adopting a literal interpretation of the dual mandate as stated in 1977? Interestingly, the opposite is true. The success of this period could be traced to the recognition by Chairman Volcker of the importance of the primacy of price stability for achieving the broader objectives of full employment over time.[1]

Chairman Volcker reminded us why the focus on price stability remains so important in a recent speech:

> 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—for instance to accommodate misguided fiscal policies, to deal with structural imbalances, or to square continuously the hypothetical circles of stability, growth and full employment—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].

But why is placing equal importance to the achievement of other objectives, such as full employment, so problematic? After all, the achievement of full employment is a desirable public policy objective. However, full employment is not an appropriate monetary

[1]Lindsey, Orphanides, and Rasche (2005) provide a detailed documentation of the considerations behind Volcker's reform in October 1979 that set the stage for the environment of stability that followed.

policy target. Unlike price stability, which is a goal that the Federal Reserve can properly define, measure, and achieve, a similar target for real economic activity does not exist. No reliable measures of appropriate real economic activity targets can be usefully constructed and the central bank does not have the tools to achieve any target for real economic activity without compromising the one thing it can achieve—price stability.

Theoretical models may point to various real economy targets that are compatible with price stability. For example, some theories focus on the unemployment rate and derived "natural rate" concepts. However, such theories do not provide practical guidance. Alan Greenspan, who succeeded Paul Volcker as chairman of the Federal Reserve and shared his understanding of the primacy of price stability, explained the challenge as follows:

> While the idea of a national "threshold" at which short-term inflation rises or falls is statistically appealing, it is very difficult in practice to arrive at useful estimates that would identify such a natural rate. . . . In light of these uncertainties, I do not think that any one estimate of the natural rate is useful in the formulation of monetary policy [Greenspan 1994].

For more than a quarter century, the chairmen of the Federal Reserve believed that to best fulfill the mandate of the institution it was key to focus on preserving price stability and avoid relying on any real economic activity targets. Their assessment was shared by many others, and proposals were made in Congress to modify the mandate of the Federal Reserve to reflect this view.[2] However, the statutory mandate of the Federal Reserve remained unchanged, and the robustness of the institution's defense of price stability continued to rest on the interpretation of its statutory mandate.

What about the present? Unfortunately, judging from recent statements, the Federal Reserve may have deviated from the interpretation of the mandate that had been adopted during the

[2]Such efforts included the "Zero Inflation Resolution" introduced in 1989, the "Economic Growth and Price Stability Act of 1995," and subsequent proposals.

Volcker-Greenspan era. Consider the quote below from the December 2012 FOMC statement:

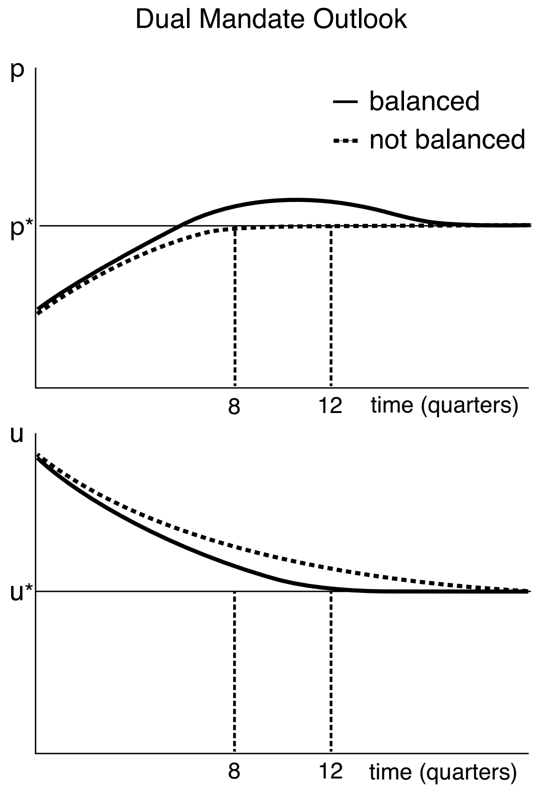
> Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. . . . [T]he Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will 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 [Federal Open Market Committee 2012].

In this statement, the Committee suggests a more literal interpretation of the dual mandate that appears to downplay the primacy of price stability and explicitly introduces a numerical threshold on the unemployment rate as a guide for monetary policy.

Elevating the role of the unemployment rate as a policy goal or guide, necessarily diminishes the importance of price stability as a goal or policy guide. Interpreted in this manner, the dual mandate can become a justification for letting inflation rise beyond what the Federal Reserve considers consistent with price stability. Pursuing an inflationary policy could be justified as necessary to achieve better outcomes with respect to its employment objective.

Figure 1 reproduces a figure from a recent speech by Narayana Kocherlakota (2013), a member of the Committee who recommends pursuing an inflationary policy on the basis of this argument. The figure compares two policies. One policy aims to achieve price stability over the policy horizon of two years while an alternative policy seeks to raise inflation above the Federal Reserve's price stability objective at that horizon. According to Kocherlakota, the policy aimed at achieving price stability is "not balanced" because it leaves the unemployment rate higher than desired. Instead it is considered preferable to adopt an easier policy stance aiming to drive inflation above its price stability objective. According to this line of reasoning, this policy would be "balanced" because it would guide the unemployment rate faster to its target. In contrast to this interpretation, what is described in the figure as "not balanced" would be the more appropriate guide for a policy that respected the primacy of price stability.

FIGURE 1
Price Stability vs. a Dual Mandate: A Conflict?



Source: Kocherlakota (2013).

What Could Go Wrong?

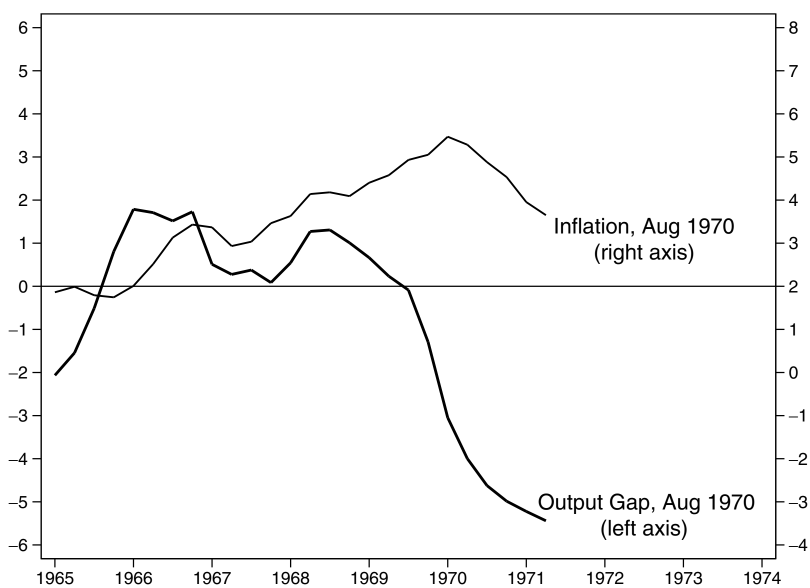
What could go wrong when policy loses sight of price stability as its primary goal? An example can be drawn from the 1970s, the earlier period in the history of the Federal Reserve when the primacy of price stability was not respected. As an example, it is instructive to focus on one FOMC meeting, in August 1970, drawing on the excellent documentation that the Federal Reserve provides about the historical monetary policy decisions of the Committee.

In the summer of 1970, the economy was recovering from a recession. Similarly to the recent experience, many policymakers were frustrated with the pace of the recovery. The economy was growing, but the unemployment rate remained high and staff analysis suggested that extensive underutilization of resources was expected to persist for a considerable time. Inflation was somewhat higher than desired and policy should have been tightened if the FOMC wished to restore price stability, as would have been called for had the Federal Reserve properly recognized the primacy of price stability at that time. In contrast, a more "balanced" approach suggested that easier policy was needed to make faster progress in closing real-activity utilization gaps. Continuing inflation was not viewed as a threat in light of these gaps. Staff analysis also suggested that

> the upturn would be starting from a point where there is substantial underutilization of resources, as evidenced by a 5 per-cent 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 1970: 19].

Figure 2 reproduces the inflation and output gap consistent with the historical data as available up to 1970Q2, and staff forecasts for

FIGURE 2
Inflation and Output Gap: August 1970



subsequent quarters as shown in the Greenbook. The horizontal axis shows zero for the output gap (left axis) and two for inflation (right axis) to reflect the Federal Reserve's implicit goals, though at that time the Committee had not yet stated explicitly its definition of price stability. Based on the staff analysis and forecasts, a member of the Committee noted:

> If those projections were realized, however, the gap between actual and potential real GNP would be between 5.5 and 6 percent by the second quarter of 1971. In his judgment, that was not satisfactory as a goal of policy [Federal Open Market Committee 1970: 45].

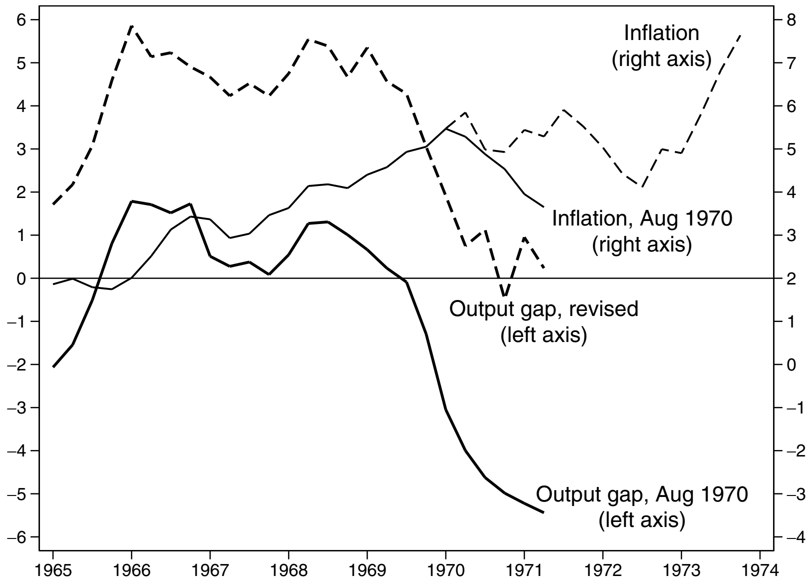
The policy conclusion was that easier monetary policy was needed to achieve a more "balanced" path for inflation and the output gap. Easier policy would close the output gap faster, while inflation would remain on the right track and eventually decline toward 2 percent. Based on this analysis and the desire to make faster progress towards full employment, the FOMC eased policy at that meeting and maintained excessively accommodative conditions for a long time.

In retrospect, this proved a grave error as the accommodative policy pursued led to the Great Inflation of the 1970s. What went wrong can be seen in Figure 3, which compares the data and forecasts available in August 1970 to revised data and estimates of corresponding concepts that became available much later.[3]

Inflation did not decline in 1971, as had been forecast by the staff in August 1970, but remained elevated and later increased further. The reason can be seen in the dramatic reassessment of the output gap. Rather than a negative output gap in 1970 that was forecast to widen to "between 5.5 and 6 per cent by the second quarter of 1971," subsequent revisions in estimates pointed to a severely overheated economy in 1970. Reliance on a measure of real economic activity as a policy guide misled the Committee.

[3]The revised series show inflation of the GDP deflator and the output gap, based on Federal Reserve estimates of potential GDP, as available in 1994. The August 1970 concepts refer to the GNP gap and deflator. See Orphanides (2003) for more details and documentation regarding data sources and revisions.

FIGURE 3
Inflation and Output Gap



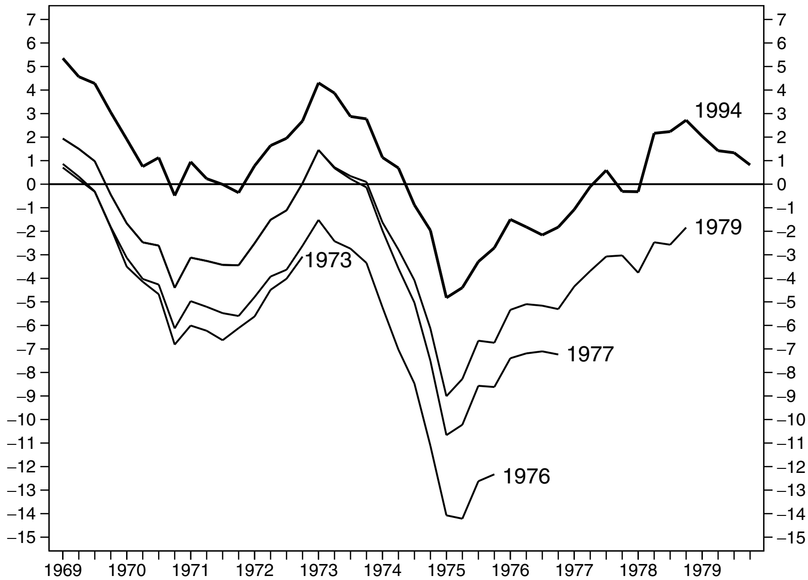
Unfortunately, the error was only gradually recognized over time. Despite successive downward revisions to potential GNP, estimates remained overly optimistic and perceived output gaps excessively negative throughout the 1970s. This can be seen in Figure 4 (reproduced from Orphanides 2003), which compares output gap estimates as available in 1973, 1976, 1977 and 1979 with the 1994 estimate that was also plotted in Figure 3.

In 1970, the staff of the Federal Reserve and the FOMC thought that the easy money policy pursued at the time was consistent with achieving full employment and price stability. The policy appeared to be "balanced." The mismeasurement of what constituted the proper target for real economic activity was only recognized when it was already too late to correct the error. The easy money policy of 1970 morphed into the stagflation of the 1970s.

Is This Time Different?

Do concerns about the inappropriateness of pursuing real economic activity targets remain justified today? Or have the

FIGURE 4
OUTPUT GAP REVISIONS



uncertainties faced in the past been resolved? The Federal Reserve releases its own analysis to the public with a lag so one cannot yet examine recent revision patterns and errors. But an examination of the evolution of the estimates of potential output produced by the Congressional Budget Office (CBO) may provide useful hints.

Figure 5 plots the path of quarterly real GDP against vintages of potential GDP as estimated by the CBO in 2007, 2010 and 2013.[4] Figure 6 compares the estimates of the output gap that correspond to the three alternative estimates of potential output. The results illustrate that this time is not different. Revisions in estimates of real economic activity targets remain an important unknown. Employment and production measures continue not to be appropriate targets for central banks.

[4]Orphanides (2013) provides additional details on these data.

FIGURE 5
GDP and Revisions of CBO Potential GDP Estimates

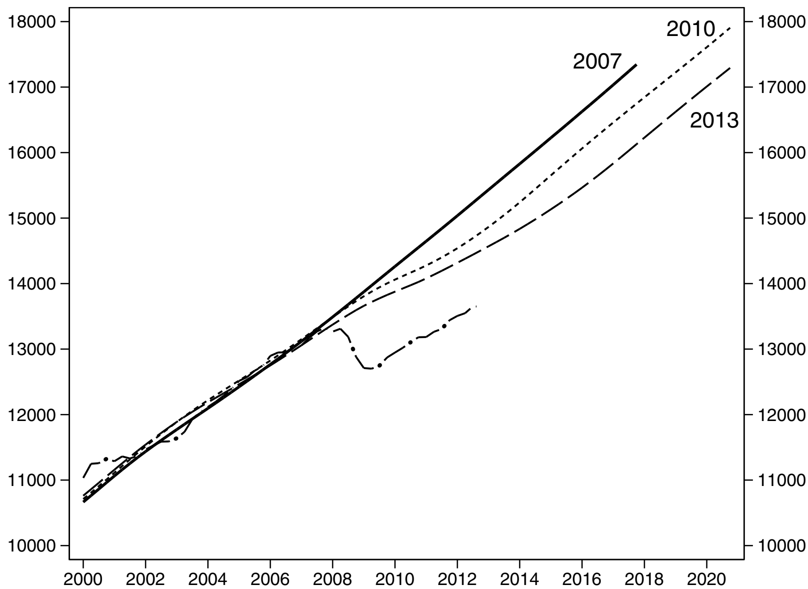
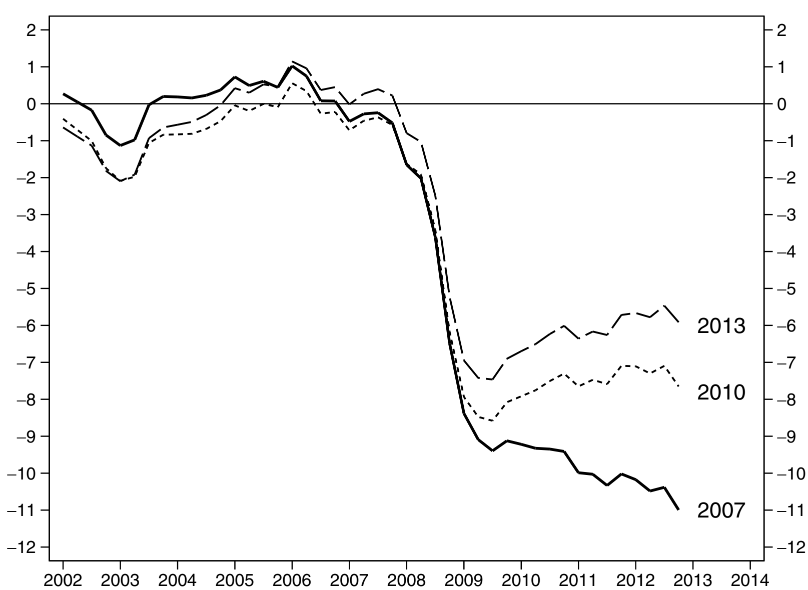


FIGURE 6
Revisions of Output Gap Estimates



Conclusion

The unprecedented expansion of the balance sheet of the Federal Reserve observed over the past year, despite the continued improvement in the economy, raises concerns. The continuing increases in monetary policy accommodation have been justified on the basis of the "dual" mandate of the Federal Reserve and the need to "foster maximum employment." Excessive emphasis on reducing the rate of unemployment, however, risks compromising price stability.

The risks emanate from the lack of clarity of the mandate of the Federal Reserve, as currently stated in the Federal Reserve Act. A clearer mandate that properly acknowledges the primacy of price stability as the means for advancing maximum sustainable growth and employment over time would greatly reduce the likelihood of repeating past mistakes and would better ensure that the Federal Reserve will safeguard monetary stability going forward.

The Fed needs a clearer mandate for its second hundred years. What is required is an Act of Congress to make price stability the primary objective of the Federal Reserve.

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