A PROPOSAL TO CLARIFY THE FED'S POLICY MANDATE

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Importance of Evaluating Monetary Policy

Some people might wonder why the Federal Reserve's policy-making function would interest anyone at this particular point in history. After all, the general economic and financial picture at present is reasonably bright. Although the rate of real economic growth has slowed somewhat from the exceptionally robust pace of the first six quarters of the recovery, overall activity is still rising. Further, in the financial arena, interest rates have declined significantly in recent months, the nervousness that was so prevalent in banking and securities markets has diminished, and equity prices are at historically high levels. Finally, and perhaps most important from a longer run perspective, the inflation rate has remained low by the standards of recent years, to the surprise of some economists who had expected the rate to be moving back up by now. To be sure, the nation still faces a number of serious economic problems. But the most pressing difficulties would seem to lie in the areas of fiscal and trade policies rather than monetary policy per se.

There are at least some people, however, who believe that monetary policy is still an appropriate topic for discussion. Two reasons can be given for this continued interest. First, some economists believe that the dangers presented by the federal deficit have been exaggerated and that the more important near-term threat to the business expansion and future prosperity is the possibility of an excessively restrictive monetary policy. This concern that Fed policy

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might be too tight has diminished in recent months as interest rates have declined and growth in the money supply has resumed, but it is likely to reemerge quickly if economic activity turns out to be weaker in the months ahead than is now anticipated.

Second—and in my personal view, more important—it is by no means clear that the longer run inflation problem has disappeared. For one thing, the recent inflation performance looks favorable only when compared to the exceptionally rapid increases in the price level in the late 1970s and early 1980s. In this regard, it is worth recalling that the inflation rate when the Nixon price control program was imposed in August 1971 was very nearly the same as it is today—about 4 percent. It is also worth remembering that an inflation rate of 4 percent leads to a doubling of the price level every 17.5 years.

If households and business firms could know for certain that inflation would remain at 4 percent indefinitely, maybe they could adjust to it and live with it. Even though longer run inflationary anticipations are probably lower now than they were a year ago, however, I do not sense any strong or widespread conviction that moderate inflation is here to stay. On the contrary, I think that many people are aware that measured inflation is currently being held down at least to some extent by the strength of the dollar in the foreign exchange markets and by the decline in oil prices. They realize that somewhere down the road the favorable effect of these conditions on the price level may disappear and that, if and when it does, the risk of another round of high inflation will increase.

It would seem then that inflation—despite a significant slowing—is still a serious problem in the sense that it could well reaccelerate in the future in an unpredictable and therefore highly disruptive manner. That possibility alone is enough to make an evaluation now of the strategy of monetary policy worthwhile. At the same time, the generally favorable immediate conditions I noted earlier may enable us to conduct this evaluation with a broader and longer run perspective than would be possible if current Fed policy were a pressing current political issue.

Ambiguous Nature of the Fed's Legislative Mandate

It is generally true that a clear and attainable objective is a necessary condition for the success of any policy strategy. As I have argued elsewhere, however, it is not at all obvious that Fed monetary policy has such an objective (Black 1984). This lack of an attainable objective is largely the result of the ambiguous nature of the Fed's legislative mandate. The most direct statement of the current mandate is contained in Section 2A of the Federal Reserve Act, as amended by the Humphrey-Hawkins Act of 1978. This provision states that Fed policy should promote maximum employment, stable prices, and moderate interest rates. These objectives are to be pursued "effectively." Further, they are to be pursued with due attention to production, investment, real income, productivity, and international trade and payments, as well as employment and prices. No guidance is given regarding the priorities of these various objectives or the time horizon over which the Fed's success in achieving them is to be evaluated.

It should be obvious to anyone that a mandate which instructs the Fed, in essence, to pursue all desirable economic objectives is no basis for an effective strategy for monetary policy. Such a broad mandate merely transfers all of the hard strategic choices regarding priorities, time frames, and what is and what is not feasible to the Fed, which is in no position to make them precisely because it has no clear mandate. In short, the lack of specificity in the Fed's mandate puts it in a Catch 22 position.

In practice, of course, policy choices have to be made, and they are made. Because there is no operationally meaningful objective, however, the choices are necessarily made in a highly discretionary manner that gives substantial weight to current, very short-run economic and financial conditions. I use the word *necessarily* quite deliberately. Because the Fed's current mandate includes so many diverse objectives, it is constantly under pressure to correct whatever economic problem is perceived to be most pressing at the moment, whether it be high interest or exchange rates, unemployment, inflation, or something else. In this kind of situation, the Fed must have the flexibility to react quickly and decisively to emerging economic conditions and to particular economic and financial problems as they arise. Viewed from this perspective, the frequent references of many Fed officials to the need for discretion and judgment in conducting monetary policy on a day-to-day basis are not difficult to understand.

I believe that a fairly convincing case can be made that any public institution with as many diverse responsibilities as the Fed must have some degree of freedom to deal with contingencies. But the dangers associated with conducting monetary policy in a predominantly discretionary manner that focuses principally on the current state of the economy are well known. First, monetary policy actions affect the economy with long and variable lags. These lags, coupled with the inability of economists to forecast future economic conditions with high confidence, present the risk that a highly discretionary policy will tend more to destabilize the economy than to stabilize it. Second, a discretionary approach to policy fosters the notion that the Fed is able to fine tune the economy satisfactorily even in the absence of compelling evidence that such is the case. Finally—and somewhat paradoxically—discretionary policy tends to subject the Fed to the political pressures of the day, an outcome that its framers were eager to avoid. Whenever special interest groups realize that the Fed conducts monetary policy in a discretionary manner, they typically increase the pressure they put on the Fed to pursue the particular goals they consider important.

For all of these reasons, it would seem to make sense to narrow the Fed's mandate in order to reduce its need to rely heavily on discretion in conducting policy. Such a narrowing would enable the Fed to develop a cohesive strategy with clear and feasible objectives and, in my opinion, would very likely improve the quality of monetary policy over time.

Narrowing the Fed's Mandate to Price Stability

If you have accepted my argument to this point, I would like to recommend a particular objective to be the preeminent and perhaps even the unique goal of monetary policy—price stability. By price stability I mean, of course, stability in the aggregate price level or, what amounts to the same thing, stability in the general purchasing power of money. I realize that this is not a new idea.[1] I also recognize that a detailed recommendation would have to specify very precisely the meaning of the word "stability." The general notion of price stability should be sufficiently concrete, however, to allow me to make my main points.

There are a number of good reasons for elevating price stability to a predominant position among the objectives of monetary policy. Let me focus just briefly on three that seem especially important to me.

First, price stability is a feasible objective for Fed policy. The close longer run correlation between the growth of monetary aggregates and the price level is one of the most firmly established empirical relationships in economics. It is true that institutional changes, technological advances, and other developments sometimes distort this relationship temporarily. But the technical ability of the Fed to stabilize the price level over a period of years through longer run control of the monetary aggregates is not seriously disputed. Since there is widespread agreement that price stability is a feasible goal for monetary policy, adopting it as the principal goal would almost certainly increase the credibility of Fed policy substantially.

[1]See Fisher (1934) for an interesting account of earlier proposals.

Second, while there is general agreement that the Fed can achieve price stability through monetary policy, there is much less agreement regarding the Fed's ability to influence the other variables mentioned in its current mandate in a systematic and socially beneficial way—particularly real variables such as employment and production. Back in the 1960s, when the Phillips curve literature and the idea of a trade-off between inflation and employment were the intellectual basis for much macroeconomic policy, many economists believed that monetary policy could contribute to the close control of real variables. A major conclusion of monetary research in the 1970s and 1980s, however, is that efforts to manipulate real variables will be thwarted by changes in the rate of inflation expected by the public. For example, efforts to "stimulate" real activity by increasing the rate of growth of monetary aggregates will raise the rate of inflation anticipated by business firms and workers and result in an increase in nominal wages and prices. This result, of course, is just an elaboration of a central theme of classical monetary economics. In any case, it makes little sense in these circumstances to charge the Fed with active responsibility for the maintenance of high employment, even though high employment is obviously a desirable economic result. The most that can reasonably be expected of monetary policy in this area is the avoidance of monetary surprises that can cause painful and costly temporary variations in employment and output around their longer run trends.

The third reason I favor price stability as the principal objective for Fed policy cannot be stated and defended as rigorously as the two just noted, but I think it is an important reason nonetheless. Specifically, I think a convincing argument can be made that raising the priority of price stability would be consistent with the basic constitutional monetary powers granted to the government by the people.[2] The Constitution contains two monetary clauses: Article I, section 8, authorizes the federal government to coin money and regulate its value; Article I, section 10, forbids the states to coin money, issue bills of credit, or make anything other than gold and silver legal tender.

I do not believe there is any firm evidence that the framers of the Constitution intended the phrase ". . . regulate the value thereof . . ." in Article I, section 8, to require the federal government to vary the quantity of money with a view to fixing or otherwise stabilizing the

[2]The argument in this and the following paragraph was strongly influenced by the discussion of the monetary clauses of the Constitution in Hammond (1957, pp. 89–113).

price level. It is more likely that the term "value" was intended to refer to the value in terms of specie of the money the government was authorized to coin, since there can be little doubt that the Founding Fathers intended to establish and to insure the perpetuation of a bimetallic commodity standard. It seems clear, however, that the two clauses were intended among other things to preclude the issue of fiat money by either the states or the federal government. It is true that only the states were expressly forbidden to issue fiat money. But it was clearly understood at the time the Constitution was written that the federal government was to have only the powers expressly granted to it, while the states were to retain all powers not expressly denied to them. This intention to preclude fiat money was almost certainly motivated by the disastrous experience with the continental currency and can be correctly viewed as an implied intention to create a monetary system in which price stability would be an inherent characteristic. I do not believe that a comparable argument can be mustered for any of the other objectives cited in the Fed's present legislative mandate.

Much has happened to our monetary institutions since 1789. The apparent intention of the framers to prevent the issue of fiat money by the government did not succeed, and we now have in essence a fiat money system. Making price stability the preeminent objective of monetary policy within the framework of the present system, however, would foster what appears to have been a preeminent implicit monetary objective of the Founding Fathers.[3]

Monetary Targeting as the Appropriate Policy Strategy

Now that I have summarized the case for restricting the Fed's macroeconomic mandate to price stability, let me just touch briefly on the choice of a strategy to achieve this goal. As I see it, the choice of a strategy is secondary to the adoption of price stability as the primary objective of policy, but it is nonetheless an important issue.

Any number of strategies for achieving price stability are possible. Some have suggested returning to the gold standard or adopting some

[3]It should be noted here that an attempt to incorporate an explicit price stabilization mandate in the original Federal Reserve Act was defeated. Several further attempts in the 1920s also failed. In this period, however, the United States was still officially on the gold standard. Much of the opposition to these proposals seems to have resulted from the belief that the adoption of an explicit price stability objective would have amounted to a questionable substitution of Federal Reserve discretion for the automatic features of the gold standard. See Fisher (1934, pp. 148–85).

other commodity standard. Another possibility would be to adopt a rule under which the Fed would vary its policy instruments in some automatic or quasi-automatic way in reaction to deviations of the inflation rate, nominal GNP, or perhaps some other variable from a desired longer run path.

There is something to be said for each of these proposals in the light of recent experience, but each of them raises technical and in some cases political questions that would be difficult to resolve. With this in mind, it seems to me that the best approach at least for the time being would be to pursue price stability through a more determined application of the monetary targeting procedure we already have in place.

I am well aware of the questions that have been raised regarding the current procedure. On one side of the question, some economists believe that financial innovation and the deregulation of interest rates have reduced the predictability of the relationship between the growth of the monetary aggregates and the behavior of the price level and other economic variables. The disruptive initial impact of interest rate deregulation is now behind us, however, and it is not unreasonable to suppose, with most interest rate ceilings removed, that financial innovation will proceed at a slower and steadier pace in the years ahead. With this in mind, I think there is every reason to believe that a gradual reduction over time in the actual growth of the monetary aggregates would be sufficient to achieve price stability. My own feeling is that M1 would be the best aggregate for the Fed to focus on at present for a number of practical reasons. If conditions make it more practical to emphasize some other measure in the future, I would certainly support a change.

Other economists are skeptical of our current monetary targeting procedure for different reasons. In particular, these economists believe that certain features of the present procedure such as the use of single rather than multi-year targets and the allowance of so-called base drift significantly reduce the likelihood that the *actual* growth in the aggregates will in fact be reduced in the context of a basically discretionary approach to policy.[4] Such skepticism is not unreasonable in view of the experience with the present targeting procedure over the last decade. This simply underlines, however, my point that an unambiguous price stability mandate is essential to the success of *any* particular strategy for achieving it. Having said that, I do believe

[4]The term "base drift" refers to the present practice of using the *actual* rather than the target level of each monetary aggregate in the base year as the base for the target in the next year.

that the adoption of a multi-year target band, along the lines of the suggestion Poole made several years ago, would be a strong incremental improvement in the present procedure.[5]

Summary and Conclusion

The main points of this paper can be summarized as follows. First, although the general economic picture is brighter than usual at present, we still face a number of longer run problems. In particular, despite the sustained period of lower inflation in recent years, there is no basis for concluding that price stability has been permanently achieved. Therefore, a reevaluation of the strategy of monetary policy at this time is appropriate. Second, a case can be made that the most constructive change that could be brought about at present would be to narrow the Fed's mandate in order to specify the objective of policy in an operationally meaningful way. The present mandate essentially forces the Fed to follow a discretionary approach that, among other things, undermines the Fed's independence. Third, if a decision to narrow the Fed's mandate is made, strong consideration should be given to elevating price stability to a preeminent position among the objectives of Fed policy because price stability is a more feasible objective than others that might be considered, and raising it to a predominant position would be consistent with the intent of the authors of the monetary clauses of the Constitution. Finally, while a number of specific monetary strategies for pursuing price stability are possible, a more determined application of the present strategy of targeting monetary aggregates along with some incremental technical changes in the present targeting procedure should be sufficient to achieve the objective over time.

In conclusion, I hope some of my comments will help to promote a public dialogue on the Fed's mandate. Beginning such a dialogue at present would seem to be especially promising. The credibility of monetary policy is unusually high now. An effort to specify our objective more clearly would build on this base and help extend our improved performance. In addition, as I suggested at the outset, it would probably be more fruitful to tackle some of the longer term issues I have raised now when the economy is performing relatively well rather than later when the Fed may be under intense political pressure to deal with some pressing immediate problem.

[5]See Poole (1976, pp. 247–59).

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