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## The Goals of U.S. Monetary Policy

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The Federal Reserve has seen its legislative mandate for monetary policy change several times since its founding in 1913, when macroeconomic policy as such was not clearly understood. The most recent revisions were in 1977 and 1978, and they require the Fed to promote both price stability and full employment. The past changes in the mandate appear to reflect both economic events in the U.S. and advances in understanding how the economy functions. In the twenty years since the Fed's mandate was last changed, there have been further important economic developments as well as refinements in economic thought, and these raise the issue of whether to modify the goals for U.S. monetary policy once again. Indeed, a number of other countries—notably those that adopted the Euro as a common currency at the start of this year—have accepted price stability as the new primary goal for their monetary policies.

In this *Letter*, we spell out the evolution of the legislation governing U.S. monetary policy goals and summarize the debate about whether they could be improved.

### **The evolution of the Fed's legislative mandate**

The Federal Reserve Act of 1913 did not incorporate any macroeconomic goals for monetary policy, but instead required the Fed to “provide an elastic currency.” This meant that the Fed should help the economy avoid the financial panics and bank runs that plagued the 19th century by serving as a “lender of last resort,” which involved making loans directly to depository institutions through the discount windows of the Reserve Banks. During this early period, most of the actions of monetary policy that affected the macro economy were determined by the U.S. government's adherence to the gold standard.

The trauma of the Great Depression, coupled with the insights of Keynes (1936), led to an acknowledgment of the obligation of the federal government to prevent recessions. The Employment Act of 1946 was the first legislative statement of these macroeconomic policy goals. Although it did not specifically mention the Federal Reserve, it required the federal government in general to foster “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.”

The Great Inflation of the 1970s was the next major U.S. economic dislocation. This problem was addressed in a 1977 amendment to the Federal Reserve Act, which provided the first explicit recognition of price stability as a national policy goal. The amended Act states that the Fed “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.” The goals of “stable prices” and “moderate long-term interest rates” are related because nominal interest rates are boosted by a premium over real rates equal to expected future inflation. Thus, “stable prices” will typically produce long-term interest rates that are “moderate.”

The objective of “maximum” employment remained intact from the 1946 Employment Act; however, the interpretation of this term may have changed during the intervening 30 years. Immediately after World War II, when conscription and price controls had produced a high-pressure economy with very low unemployment in the U.S., some perhaps believed that the goal of “maximum” employment could be taken in its mathematical sense to mean the highest *possible* level of employment. However, by the second half of the 1970s, it was well understood that some “frictional” unemployment, which involves the search for new jobs and the transition between occupations, is a necessary accompaniment to the proper functioning of the economy in the long run.

This understanding went hand in hand in the latter half of the 1970s with a general acceptance of the Natural Rate Hypothesis, which implies that if policy were to try to keep employment above its long-run trend permanently or, equivalently, the unemployment rate below its natural rate, then inflation would be pushed higher and higher. Policy can *temporarily* reduce the unemployment rate below its natural rate or, equivalently, boost employment above its long-run trend. However, persistently attempting to maintain “maximum” employment that is above its long-run level would not be consistent with the goal of stable prices.

Thus, in order for maximum employment and stable prices to be mutually consistent goals, maximum employment should be interpreted as meaning maximum *sustainable* employment, referred to also as “full employment.” Moreover, although the Fed has little if any influence on the long-run level of employment, it can attempt to smooth out short-run fluctuations. Accordingly, promoting full employment can be interpreted as a countercyclical monetary policy in which the Fed aims to smooth out the amplitude of the business cycle.

This interpretation of the Fed’s mandate was later confirmed in the Humphrey-Hawkins legislation. As its official title—the Full Employment and Balanced Growth Act of 1978—clearly implies, this legislation mandates the federal government generally to “...promote *full employment and production*, increased real income, balanced growth, a balanced Federal budget, adequate productivity growth, proper attention to national priorities, achievement of an improved trade balance . . . and *reasonable price stability*...” (italics added).

Besides clarifying the general goal of full employment, the Humphrey-Hawkins Act also specified numerical definitions or targets. The Act specified two initial goals: an unemployment rate of 4% for full employment and a CPI inflation rate of 3% for price stability. These were only “interim” goals to be achieved by 1983 and followed by a further reduction in inflation to 0% by 1988; however, the disinflation policies during this period were not to impede the achievement of the full-employment goal. Thereafter, the timetable to achieve or maintain price stability and full employment was to be defined by each year’s *Economic Report of the President*.

### **The debate about the Fed’s current mandate**

The Fed then has two main legislated goals for monetary policy: promoting full employment and promoting stable prices. With this mandate, the Fed has helped foster the exceptional performance of the U.S. economy during the past decade. Still, some have argued that the Fed’s mandate could be improved, especially in looking ahead to future attempts to maintain or institutionalize recent low inflation. Much discussion has centered on two topics: the transparency of the goals and their dual nature.

The transparency of goals refers to the extent to which the objectives of monetary policy are clearly defined and can be easily and obviously understood by the public. The goal of full employment will never be very transparent because it is not directly observed but only estimated by economists with limited precision. For example, the 1997 *Economic Report of the President* (which has authority in this matter from the Humphrey-Hawkins Act) gives a range of 5 to 6% for the unemployment rate consistent with full employment, with a midpoint of 5.5%. Research suggests that there is a very wide range of uncertainty around any estimate of the natural rate, with one prominent study finding a 95% probability that it falls in the wide range of 4 to 7-1/2 % (see Walsh 1998).

Price stability as a goal is also subject to some ambiguity. Recent economic analysis has uncovered systematic biases, say, on the order of 1 percentage point, in the CPI’s measurement of inflation (see Motley 1997). In this case, actual price stability would be consistent with measured inflation of 1%. In addition, at any point in time, different price indexes register different rates of inflation. Over the past year, for example, the CPI has risen about 1-1/2%, while the GDP price index

has risen about 1%. Still, a transparent price stability goal could be specified as a precise numerical growth rate (or range) for a particular index (which could take into account any biases). However, economists have also suggested other ways to enhance the transparency of policy. For example, publishing medium-term inflation forecasts might help to clarify the direction of policy (Rudebusch and Walsh 1998). Because the central bank has some control over inflation in the medium term, its forecasts would contain an indication of where it wanted inflation to go.

A second recent proposed modification to the Fed's goals involves focusing to a larger extent on price stability and de-emphasizing business cycle stabilization. Some economists have argued that having dual goals will lead to an inflation bias despite the Fed's best attempts to control inflation. This argument stresses that the temptation to engineer gains in output in the short run will overcome the central bank's desire to control inflation in the long run. As a result of elevated inflation expectations of the public, inflation will end up being higher than the central bank intended, despite its best efforts. This "time-inconsistency" argument, as economists call it, coupled with the pain incurred in the 1970s as inflation skyrocketed and in the early 1980s as inflation was reduced to moderate levels, persuaded many that the primary goal of the central bank should be to stabilize prices.

This view is embodied in the charter for the central bank in the new European Monetary Union: "The primary objective of the European System of Central Banks is to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community." Among these latter policies are "a high level of employment" and "a balanced development of economic activities."

Economists remain divided on the importance of the time inconsistency problem and on the need to put primary emphasis on price stability at the expense of output stabilization. Some stress the fact that the central bank is the only entity that can guarantee price stability, and that this goal is not likely to be attained for long unless price stability is designated as the primary goal. Others find the arguments for time inconsistency implausible because policymakers, who are aware of the arguments about an inflationary bias and see the implications for

inflation, can conduct policy without an inflationary bias (McCallum 1995). Still others argue that the abdication of other goals is irresponsible (Fuhrer 1997). Also, a good deal of empirical research using simulations of models of the U.S. economy suggests that a focus on dual goals can reduce the variance of real GDP (i.e., smooth the business cycle) while achieving an inflation goal as well (Rudebusch and Svensson 1998).

While these issues are not yet resolved, the experience of the past two decades provides some support to those who think dual goals that lack transparency can function successfully. It is true that some countries around the world have reduced inflation over this period while putting primary emphasis on explicit inflation targeting. But at the same time, with its current legislative mandate, the Fed also has had success in reducing inflation, while maintaining the flexibility of responding to business cycle conditions.

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