Innovations to Federal Reserve Strategy:
Opportunities Seized and Opportunities Lost

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Opportunities Seized

The Federal Open Market Committee has taken a giant step forward, acting decisively to clarify its long-run objectives. Two paragraphs from page 8 of the minutes of the January 24-25 meeting identify and explain these goals:

> The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. Communicating this inflation goal clearly to the public helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant economic disturbances ....
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> In setting monetary policy, the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level. These objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

In these two paragraphs, FOMC members summarize, skillfully and clearly, several of the most basic and robust lessons about the effects of monetary policy that have been developed, over more than two centuries, by scholars including David Hume, Milton Friedman, Robert Lucas, Finn Kydland, and Edward Prescott.

The first and most important lesson dictates that, in Friedman's (1968a, p.39) famous words, "inflation is always and everywhere a monetary phenomenon." The practical implication of this lesson, embedded fully into the FOMC's statement, is that a central bank like the Federal Reserve can choose whatever numerical target for inflation it finds most appropriate and then, through the proper calibration of its monetary policy actions, hit this target, with a high degree of accuracy, over a period of years. The intellectual origins of the second and third lessons are described in more detail in my previous SOMC position paper (Ireland 2011). These lessons explain how, by stabilizing inflation over the long run, a central bank can simultaneously insulate output and employment as best it can against a variety of disturbances that may affect the economy in the short and medium terms. These lessons also indicate that, in exceptional cases where a painful trade-off between stabilizing inflation and stabilizing output and employment does arise, a central bank can secure for itself the most favorable terms in managing this trade-off by committing, first and foremost, to price stability in the long run. Both of these lessons, too, are reflected quite clearly in the FOMC's statement.

All of this is quite impressive. With two paragraphs of text, the FOMC has formalized its commitment to stabilizing inflation as its overarching monetary policy strategy. And the move comes at exactly the right time. Against the backdrop of heightened uncertainty that continues to prevail in the aftermath of the financial crisis of 2008 and the "Great Recession" that followed, Chairman Bernanke and his associates have removed, singlehandedly, one major source of unease among American consumers, workers, businesses, and financial market participants. What will the average annual rate of inflation be in the United States over the next decade? We now know the answer: 2 percent. For seizing the opportunity to provide us with this answer in no uncertain terms, Chairman Bernanke, the other Federal Reserve Governors, and the Federal Reserve Bank Presidents deserve our most sincere thanks and our most hearty congratulations!

Opportunities Lost

A third paragraph, omitted from the quotation above, stands in between the other two. It reads:

> The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision. The Committee considers a wide range of indicators in making these assessments. Information about Committee participants' estimates of the longer-run normal rates of output growth and unemployment is published four times per year in the FOMC's Summary of Economic Projections. For example, in the most recent projections, FOMC participants' estimates of the longer-run normal rate of unemployment had a central tendency of 5.2 percent to 6.0 percent, roughly unchanged from last January but substantially higher than the corresponding interval several years earlier.

To an extent, the language in this paragraph also echoes Milton Friedman's. As Friedman explains (1968b), although monetary policy is responsible for determining the long-run behavior of nominal variables like inflation, it cannot exert any lasting influence over real variables like output and employment. These ideas, often referred to as the "classical dichotomy" and the doctrine of "long-run monetary neutrality," also extend all the way back to the eighteenth-century writings of David Hume. Importantly, the FOMC's statement recognizes that the Federal Reserve cannot choose a target for unemployment in the same way that it can choose a target for inflation.

But the FOMC's statement recognizes something more. Not only is the long-run unemployment rate beyond the Fed's control, it is also unknown and volatile: the best estimates from the best economists of this normal or "natural" rate of unemployment are surrounded by huge standard errors and subject to large and frequent revisions. Douglas Staiger, James Stock, and Mark Watson (1997, p.34) put it most succinctly when they summarize their own attempts to estimate the natural rate by admitting, "the most striking feature of these estimates is their lack of precision." For exactly these reasons, other central banks around the world that have adopted inflation-targeting strategies are loath to cite estimates of the natural rate of unemployment alongside their own numerical objectives for inflation. And for the same reasons, when Chairman Bernanke and co-authors Thomas Laubach, Frederic Mishkin, and Adam Posen (1999) devote the last chapter of their book on *Inflation Targeting* to outlining a detailed scenario in which the Federal Reserve sets, presents, and achieves long-run objectives for inflation, their discussion elaborates on most of the points made by the FOMC in the first two paragraphs cited above, but avoids any reference to the long-run or natural rate of unemployment like those made in the third excepted passage.

Why, then, did FOMC members risk diluting their well-earned gains, by stating together with a long-run inflation target that is now fixed, known, and can surely be achieved, estimates of the natural rate which, to the contrary, are variable, imprecise, and entirely beyond the influence of monetary policy? Some clues can be found in the minutes from previous FOMC meetings.

In particular, FOMC members began to discuss the new long-run strategies now in place at their September 20-21 meeting. Page 3 of the minutes from that earlier meeting highlight the tension noted above:

> Most participants indicated that they favored taking steps to increase further the transparency of monetary policy, including providing more information about the Committee's longer-run policy objectives and about the factors that influence the Committee's policy decisions. Participants generally agreed that a clear statement of the Committee's longer-run policy objectives could be helpful; some noted that it would also be useful to clarify the linkage between these longer-run objectives and the Committee's approach to setting the stance of monetary policy in the short and medium run. That said, a number of participants expressed concerns about the conceptual issues associated with establishing and communicating explicit longer-run objectives for the unemployment rate or other measures of labor market conditions, inasmuch as the long-run equilibrium levels of such measures are influenced importantly by nonmonetary factors, are subject to change over time, and are estimated with considerable uncertainty. In contrast, participants noted that the long-run level of inflation is determined primarily by monetary policy.

Evidence of same tension appears on page 2 of the minutes from November 1-2 meeting, at which

> Many participants pointed to the merits of specifying an explicit longer-run inflation goal, but it was noted that such a step could be misperceived as placing greater weight on price stability than on maximum employment; consequently, some suggested that a numerical inflation goal would need to be set forth within a context that clearly underscored the Committee's commitment to fostering both parts of its dual mandate.

For students of Federal Reserve history and policy, those last two words -- "dual mandate" -- provide the dead giveaway.

Clearly, many FOMC members saw the 1977 amendment to the Federal Reserve Act and the Humphrey-Hawkins legislation on which that amendment builds, as imposing binding constraints, preventing them from endorsing a full-fledged move towards an inflation-targeting strategy on par with those already adopted and used by other central banks around the world and envisioned for the United States as well by Chairman Bernanke's own previous writing on the subject. Indeed, Chairman Bernanke and his co-authors (1999, p. 325) foresaw this potential difficulty when they explained that

> The Humphrey-Hawkins legislation now in effect appears to be sufficiently broad and non-specific to make new legislation unnecessary to implement the framework we have proposed here .... Nevertheless, some modification of Humphrey-Hawkins would probably be useful. The Acts sets several goals for monetary policy, including high economic growth, low unemployment, and price stability; missing, however, is any specific reference to the time frame in which these goals are to be reached or to their order of priority. One might argue, for instance, that a focus on long-run price stability is consistent with Humphrey-Hawkins, because price stability promotes high rates of economic growth and employment in the long run. It does not always promote "maximum employment" in the short run, however, which might lead some to interpret inflation targeting as inconsistent with the Act. It would be desirable to modify the Humphrey-Hawkins legislation in the direction of the Maastricht Treaty, which specifies that price stability is the overriding long-run objective of monetary policy, but also mandates attention to other important economic goals, so long as they are consistent with long-run price stability. Such modifications would clarify the role of price stability in the conduct of monetary policy and would provide a sounder foundation for the inflation-targeting framework.

This year, Chairman Bernanke and his colleagues on the FOMC worked hard, and succeeded admirably, in finessing the contradictions inherent in the Federal Reserve's legislated mandate, using the same sound logic and good sense that Professor Bernanke and his co-authors employed for the same purpose more than a decade ago. Still, isn't it a shame that in the end, the FOMC had to combine a clear statement of what the Fed can promise and deliver -- low and stable inflation -- with an ambiguous and potentially confusing statement of what it cannot possibly achieve -- a long-run target for unemployment? All the more so because, as emphasized by Chairman Bernanke in the January 24-25 minutes (p.7), the purpose of the FOMC's announcement is not to signal "a change in the Committee's policy approach" but rather to "help enhance the transparency, accountability, and effectiveness of monetary policy." A important opportunity to go even further towards achieving the Chairman's goals seems to have been lost, in large part because of constraints imposed by the dual mandate.

A Call for Further Action

It need not -- and in most cases probably should not -- be the role of Congress to legislate morality. For we Americans have our religious leaders and our own private consciences to guide us towards what is right and away from what is wrong. Nor is it Congress' job to legislate scientific truths. For we have scientists, philosophers, and educators to help deepen our understanding of how the universe works. But when an existing piece of legislation, however noble in its original intent, gives pause to those who are attempting to do the right thing and poses obstacles for those who seek to employ technical knowledge to improve the lives of many, we might reasonably expect ethical and scientific considerations to motivate Congress to take appropriate corrective action.

Fortunately, on this point, at least, Americans should not need a fiery, Sam Adams-like character to rally us, in costume, down to the docks in protest; we should not need another General Eisenhower to lead us in all-out war against evil. We should simply ask the United States Congress, on behalf of Chairman Bernanke and his colleagues, for an amendment to the 1977 amendment to the Federal Reserve Act of 1913: a small change, to be sure, but one that would replace the dual mandate with a sharper and clearer alternative that will allow us to enjoy all of the benefits of a monetary policymaking strategy that commits, fully and unambiguously, to stabilizing prices in the long run.

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