

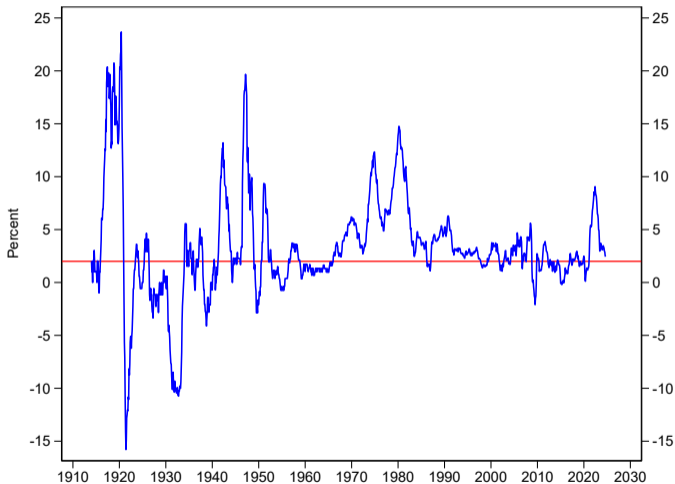
The Federal Reserve's Evolving Interpretation and Implementation of Its Mandate

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The Federal Reserve's record in maintaining price stability



Percent change of CPI for all urban consumers, year-on-year, monthly.



Evolution of the Federal Reserve's statutory mandate

- ▶ **1913:** “[The rate of discount] shall be fixed with a view of **accommodating commerce and business.**” (Federal Reserve Act, Section 14.)
- ▶ **1946:** “The Congress declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means... to promote **maximum employment, production and purchasing power.**” (Employment Act, Section 2.)
- ▶ **1977:** “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.)



The interpretation of the mandate and policy success

- ▶ Over its history, the Fed has operated with a statutory mandate that has not explicitly recognized price stability as the primary goal of monetary policy.
- ▶ The Fed's success in delivering price stability and fostering the good economic performance that is associated with it, has rested on the interpretation of the mandate and implementation of its policy strategy.
- ▶ At times, the Fed avoided the temptation to overreach and focused on defending price stability as a means of fostering growth and prosperity.
- ▶ At other times, the Fed interpreted the mandate in an overambitious fashion, raising expectations beyond what is feasible in practice.



1939: Full employment and 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: High level of employment

“The principal purpose of the Federal Reserve is to regulate the supply, availability, and cost of money with a view to contributing to the maintenance of a **high level of employment**, stable values, and a rising standard of living.”

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



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.)



1954: Orderly economic growth

“The basic function of the Federal Reserve System is to make possible a flow of credit and money that will foster **orderly economic growth** and a stable dollar. An efficient monetary mechanism is indispensable to the steady development of the nation’s resources and a rising standard of living.”

(The Federal Reserve System: Its Purposes and Functions, third edition, 1954.)



The 1970s

“Viewed in the abstract, the Federal Reserve System had the power to abort the inflation at its incipient stage fifteen years ago or at any later point, and it has the power to end it today. ...

The Employment Act prescribes that ‘it is the continuing policy and responsibility of the Federal Government to ... utilize all its plans, functions, and resources ... to promote maximum employment.’ The Federal Reserve is subject to this provision of law, and that has limited its practical scope for restrictive actions ...”

(Arthur Burns, *The Anguish of Central Banking*, 1979.)



Interpretation of mandate under Chairs Volcker and Greenspan

- ▶ During disinflation of 1980s and 1990s, under Chairs Volcker and Greenspan, the Fed avoided the trap of focusing directly on “maximum employment” .
- ▶ The Fed effectively treated price stability as a primary mandate, communicating that achieving and maintaining price stability is the best way for the central bank to contribute to maximum sustainable growth and employment over time
- ▶ The Fed’s framework: “a strategy for policy directed at maximizing the probabilities of achieving over time **our goals of price stability and the maximum sustainable economic growth that we associate with it.**” (Alan Greenspan, 2004.)



1984: Growth in line with its potential

“The Federal Reserve contributes to the attainment of the nation’s economic and financial goals through its ability to influence money and credit in the economy. As the nation’s central bank, it attempts to ensure that growth in money and credit over the long run is sufficient to encourage **growth in the economy in line with its potential** and with reasonable price stability.”

(The Federal Reserve System: Its Purposes and Functions, seventh edition, 1984.)



Interpretation of mandate in aftermath of GFC

- ▶ The GFC resulted in an increase of the unemployment rate not seen since the Great Depression. Perhaps influenced by this development, the Fed once again raised the focus on “maximum employment” as an explicit policy goal.
- ▶ In 2012, “maximum employment” was presented on equal footing with “price stability” in the Fed’s monetary policy strategy statement.
- ▶ In 2020, the prominence of “maximum employment” was elevated further:
 - ▶ Asymmetric focus on “shortfalls of employment from its maximum level.”
 - ▶ Ordering of discussion changed to place “maximum employment” first.
 - ▶ Tolerance for overshooting inflation goal introduced in strategy.



What interpretation for policy success?

- ▶ Price stability is essential for a well-functioning monetary system and fosters good economic performance over time.
- ▶ The Fed's price stability record has improved over the past 50 years.
- ▶ However, the post-pandemic inflation is an example of the inevitable policy errors that arise when the Fed loses sight of the primacy of price stability.
- ▶ With its current statutory mandate, the Fed can be more successful if it avoids the temptation to overreach.

