

# THE FED'S MANDATE: HELP OR HINDRANCE?

*Address by*

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*to the*

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It's a genuine pleasure to be with you today, to discuss a few of the major problems that are confronting us at present in, the conduct of monetary policy. I'm well aware that a discussion of a contentious topic like monetary policy may be somewhat out of keeping with the rather idyllic setting of this convention. At the same time, this secluded spot, well removed from the hectic pace of everyday business life, may well be an appropriate setting for a brief consideration of some of the broader, longer run issues with which we're grappling at the Fed, as distinct from the immediate problems that receive so much attention in the press. While I plan to mention some of our present difficulties in passing, I want to focus more specifically on some of these broader issues this morning.

## **The Present Setting**

On the surface, I suppose one could argue that the immediate economic picture is pretty bright. After all, we are presently in the sixth quarter of a vigorous economic recovery. The early stages of the upswing were powered by strong increases in both residential construction and consumer spending. These sectors are still reasonably buoyant, and they are now being supplemented by increased business spending on new plant and equipment and on inventories. The main drag on the recovery to date has been the record deficit in our merchandise trade balance, but even with this deficit real growth in the economy has proceeded at an average annual rate of 6.7 percent since the recession bottomed out in late 1982: Further, and probably best of all, during the last two years we've

enjoyed the lowest sustained rate of, inflation since the early 1970s. Indeed, my instincts tell me that this apparent progress on the inflation front is one of the reasons the recovery in business activity has been so much stronger than almost anyone expected it to be a year or so ago.

Despite this rather favorable scenario, I'm sure I don't have to tell you or any other knowledgeable observers that all is not well. Since the beginning of this year, there has been a growing uneasiness in the business and financial communities. Especially in recent weeks, expectations appear to have taken a distinct turn for the worse. There are a number of contributing factors. The discouraging failure of Congress to come to grips with the problem of the Federal deficit is a key element in the backdrop. Against that backdrop the very strength of the economic advance itself becomes something of a problem, generating as it does large increases in private credit demands and fears of a collision between private, and government, demands that could put sharp upward pressure on interest rates. The potential implications of such a collision for the international debt situation, for the stability of the banking industry and the international financial system, and for the beleaguered domestic thrift industry have become a matter of increasing concern to the financial community in recent weeks.

But most serious of all, I think, is an apparent escalation of inflationary expectations with all its adverse effects on financial markets. Such an expectations pattern tells us that public confidence in our ability to cope with our problems without causing a

resurgence of inflation is at a low ebb. Sophisticated observers of financial markets know, as we in the Fed know, that inflation is not a solution. Indeed it can be a source of only more vexing, more serious problems that could cripple our financial markets. Nevertheless, there appears to exist an undercurrent of fear that political and other pressures generated in this election year climate will be too strong for the Fed to resist.

This troubles me greatly. After all, Chairman Volcker and others of us in the System have said repeatedly that the Fed attaches an extremely high priority to sustaining and extending the recent progress in reducing inflation. And I think I'm correct in my impression that most observers, despite critical comments, believe that our intentions are firm and honest. But despite our much heralded "independence," many market professionals and others believe it will be impossible for the Fed to resist strong election year pressures to ease policy even at the risk of reigniting inflation.

Public skepticism on this point can, perhaps, find some support in past history, but I don't think it captures the essence of the problem we at the Fed face in trying to design and implement an effective anti-inflationary program. The real problem, as I see it, is not the limitations of the System's ability to withstand partisan pressure or the ability of any of its high officials to withstand such pressures. None of us who choose central banking as a career expect to win popularity contests. Rather the difficulty is the nature of the mandate that has been given to the Fed by the public through its elected representatives. I have great respect for the collective wisdom of the American people, but I have to acknowledge that I do not believe the public has acted particularly wisely or carefully in setting objectives for the Fed. I'd like to spend the remainder of my time embellishing this theme just a little bit. And in doing so I want to emphasize that all of these views are my own personal judgments. They do not necessarily reflect the views of anyone else in the System.

### **What is the Fed's Mandate?**

Suppose I were to ask you: What is the Fed's mandate in the area of monetary policy? That is, exactly what is it that the public expects the Fed to do with monetary policy? I'll bet that if I went around this room and put that question to each of you individually, I would get a wide variety of answers. Some would probably say our principal task is to hold inflation down. But others would

say it is to keep the level of real business activity and employment high, or to prevent interest rates from rising too much, or to keep the dollar from becoming either too weak or too strong in the foreign exchange markets, and so forth. Who would be right? Well, in a sense, all of you would be right because our mandate, in its present form, essentially embraces all of these objectives. Section 2A of the Federal Reserve Act, as amended, requires the Fed "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Moreover, in carrying out monetary policy, we are to "[take] account of past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices."

You don't have to be a genius to know that we at the Fed do not possess the means to achieve all of these objectives simultaneously and singlehandedly. In other words, the Fed's present mandate is unrealistically general and sweeping, particularly if viewed as a set of objectives to be achieved in the short run. In practice, this has forced the Fed to choose among competing objectives, or at least to make choices regarding the weight to give any particular objective in formulating monetary policy in the short run. At first glance, this ability to choose among objectives and to vary these choices over time might seem to increase the Fed's flexibility and hence its independence and its power. In my judgment, however, it does just the opposite: it subjects the Fed to a relentless barrage of pressure from competing interest groups trying to badger the Fed into giving greater weight to their respective points of view in setting monetary policy. Since many of these groups can argue with some justification that the Fed is mandated to achieve their favored objectives, such pressures can, in our type of political system, paralyze any effort of the Fed to set an attainable longer run objective and stick to it.

I cannot emphasize this point too strongly. Far from enhancing the Fed's independence and insulating it from partisan pressures, it seems to me that the lack of specificity in the Fed's current mandate serves to intensify these pressures, to reduce our real independence, and to prevent us from achieving any particular objective as effectively and consistently as we otherwise might. In particular, the flexibility we are thought to possess almost inevitably leads us to give substantial weight to current economic and financial conditions in deciding on current policy actions. Certainly the System should be aware of the current state of the economy and take account of any special prob-

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lems in financial markets in setting policy. But an excessive preoccupation with current conditions can lead to policy actions that destabilize the economy rather than stabilize it because of the long and unpredictable lags between the time policy actions are taken and the point at which they affect particular economic variables.

### **A Price Stability Mandate**

If you're willing to buy my argument that the all-inclusive character of the Fed's present mandate is a problem, the obvious solution to the problem is for the public to specify the objective of monetary policy more narrowly and more precisely. That would mean making a choice among competing objectives, and obviously that choice would have to be made by the public through the legislative process. If it's not too presumptuous, however, I would like to tell you what by choice of an objective would be if the choice were mine. My choice would be price stability, and what I really have in mind here is a permanent return to a very low rate of inflation. Indeed, I would go so far as to set a goal of no inflation, after making allowance for the effect of quality change and the like on measured inflation. Once the inflation genie gets out of the bottle, it is very difficult to get it back in again.

You may reasonably ask why I would choose price stability as the major objective of monetary policy rather than some other desirable objective such as high employment or low interest rates. There are several reasons. At one level, I would choose price stability because I believe that inflation and the forces that have created it are directly or indirectly responsible for much of the deterioration in our nation's economic performance over the last 20 years or so. Inflation disrupts the functioning of our financial markets and discourages saving and investment. It introduces noise into market price signals. Its volatility increases the risk associated with particular business decisions and makes planning difficult. It distorts incentives and leads to serious inefficiencies in the allocation of resources. These distortions and inefficiencies prevent us from achieving the advance-

ment in living standards we would otherwise be able to attain.

But these points alone are not sufficient to warrant choosing price stability as the prime objective of monetary policy. Someone else could always argue, with perhaps equal conviction, that high rates of unemployment are even worse than high rates of inflation, and that if it came to a choice between the two, the Fed should give greater weight to reducing unemployment. It would be very difficult-if not impossible-to resolve this kind of debate. With this in mind, I have a more fundamental reason for choosing price stability as the principal and maybe even the exclusive objective of monetary policy: namely, that price stability is the only feasible objective for monetary policy.

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“...price stability is really the only objective that it is feasible for the Fed to try to achieve with monetary policy.”

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This last point-that price stability is the only feasible objective for Fed policy-is extremely important in my opinion, so let me just flesh it out very briefly. There was a time not very long ago when economists and others believed it was possible to manage economic conditions very closely through monetary and fiscal policy. The intellectual basis for this belief was the famous Phillips Curve, which suggested that there was a trade-off between inflation and unemployment that could be exploited profitably by policymakers. In essence, it was thought that policymakers could choose any particular combination of inflation and unemployment along the Phillips Curve. If they were willing to accept a little more inflation, they could get a little less unemployment and vice-versa. This approach to policy and the confidence in the manipulative power of monetary and fiscal policy it presupposed have come to be known as “fine-tuning.”

Over the course of the last 20 years or so, this view of policy and the Phillips Curve doctrine that underlies it have been subjected to an intensely critical examination by a number of leading monetary economists. In the course of this examination, several important ideas have been developed that seriously challenge the validity of the fine-tuning approach. Let me just mention a couple of these ideas very

quickly. Like all really powerful ideas in economics, their essence can be readily grasped by anyone.

The first is the so-called natural rate hypothesis. What this says is that if there is in fact any trade-off between inflation and unemployment, it is not between actual inflation and unemployment but between that part of inflation that is *unanticipated* by the public and unemployment. As long as inflation is fully anticipated, the unemployment rate will fluctuate around its natural rate as determined by such basic economic factors as the characteristics of the labor force and the state of technology. For example, if an effort is made to stimulate employment through policies that are likely to increase inflation, and if the public in general and workers in particular foresee this increase in inflation, workers will demand an increase in wages to compensate for the expected increase in inflation, and the policies won't cause any permanent increase in employment. The implication of the natural rate hypothesis for policy, then, is that employment can be systematically fine-tuned through monetary and fiscal policy only if the public systematically and persistently misestimates the effects of these policies on the rate of inflation.

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The second idea is what is known as the rational *expectations hypothesis*. In the present context, this hypothesis holds that the public, as a whole, is intelligent and perceptive and does not systematically misestimate the inflationary impact of monetary and fiscal policies. In short, the natural rate idea says that you can fine-tune the economy through fiscal and monetary policy only if you can fool most of the people most of the time, and the rational expectations idea says you can't do that.

The implications of these ideas for 'monetary policy are both obvious and profound. In essence, they say that the Fed cannot influence real economic conditions like employment and production and real rates of interest in any predictable way over time. This leaves price stability as the only feasible objective for monetary policy. I should point out that even though

the set of ideas I've just outlined and their implications for policy are not yet universally accepted, they are embraced by a large and growing number of economists, and I personally find them very persuasive. I might also note that they are not really entirely new ideas but, like so many seemingly new concepts, have roots in the classical economics that is the foundation of our free market system.

### **The Matter of Implementation**

I need to touch just briefly on one final point, and that's the matter of implementation. If one is willing to embrace price stability as the main objective of Fed monetary policy, what's the best way to achieve it? In principle there are several ways that we might go about it. For example, there have been suggestions recently that the Fed might set explicit numerical targets for the price level and then react in some fairly mechanical way to deviations of actual price movements from these targets. There might be some advantages to this kind of procedure, but I doubt seriously that it's the best approach given the very long and variable lags in the effect of Fed policy on the price level.

More fundamentally, it is not at all clear to me that some kind of reactive mechanism is necessary. We all know that *the* one sure way for the Federal Reserve to promote price stability is to reduce, slowly but surely, the rate of growth of the nation's money supply to a steady noninflationary rate and keep it there. With this in mind, my own feeling is that the most effective way we could attain a price stability objective would be to rededicate ourselves to the monetary targeting procedure we already have in place and to take some steps to strengthen that procedure. In particular, I think there's much to be said for the idea of setting targets not only for the current year but for several years into the future. Multi-year targeting would permit the Fed to put forward an explicit longer run strategy for achieving price stability, and it would eliminate the technical problem known as "base drift" that is an important defect of the current one-year targeting procedure. (This problem arises because we always base each new year's target on where we ended the preceding year, even if we missed the preceding year's target by a substantial amount.)

Further, I think we need to focus specifically on controlling over the long run the measure of the money supply known as M1 and reduce the attention we give to broader measures of money such as M2 and M3 and aggregate measures of credit. I am well

aware of the debate that is going on among technically oriented monetary specialists over whether or not financial innovations like money market funds and the ensuing deregulation in banking markets have affected the demand for the various components of M1 in an unpredictable way and therefore reduced its usefulness as a target for monetary policy. The evidence I've seen suggests to me that for now M1 is still the best target among the various alternatives available. I don't think there is any serious reason to doubt that a policy of gradually reducing M1 growth to a noninflationary rate would allow us to achieve price stability without any excessive risk to the real economy. Having said this, let me also say that if it becomes evident in the future that some monetary measure other than M1 would be a better target for policy, I wouldn't hesitate to change. My preference for the use of M1 as a target is entirely practical rather than doctrinal.

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### **Concluding Comments**

I realize that I've covered a fair amount of ground this morning, so let me just review very summarily the main points I've tried to make. First, a case can be made that the Fed's mandate, as it is, presently structured, is so broad and general that its value as a practical guide to monetary policy is limited and at times may actually prevent policy from contributing

as much to our economic welfare as it otherwise might. Second, if the public should decide to narrow the Fed's mandate and make it more specific, the best choice of a more limited objective for Fed policy in my view would be price stability. Indeed, there are very solid reasons to believe that price stability is really the only objective that it is feasible for the Fed to try to achieve with monetary policy. I might add as a footnote here that restricting our mandate to price stability should go some distance toward satisfying those of our critics who complain that the Fed cannot be held accountable for its actions, since it would not be unreasonable to hold the Fed accountable, for the behavior of the price level over a period of, several years. Nor should we in the Fed fear such accountability since our assignment would be both feasible and unambiguous. Third and last, if price stability were our goal, my own feeling is that we could best achieve it by slowly but surely reducing the growth of M1 to a noninflationary rate under present circumstances, but I'm enough of a pragmatist to have absolutely no objection to switching to some other monetary handle if it is ever demonstrated that something else has become superior to M1.

I hope you will find these comments useful as food for thought. You in the banking industry are closer to monetary policy than people in most other industries, and we depend on you to consider these kinds of questions carefully and critically and let us know your views. I don't claim that the changes I've outlined would solve all of our nation's economic and financial problems. Far from it. Some of these problems have very deep roots, and they will not be resolved easily or quickly. Nonetheless, I am convinced that the changes I have recommended would increase our ability at the Fed to contribute to the strength and stability of the economy. In a democracy like ours, public institutions are guided ultimately by the marching orders they receive from the electorate. If we are to do our job well, it is essential that these instructions be as clear and unambiguous as possible.