

The Federal Reserve Takes an Active Hand in **Fostering Jobs** and **Stable Prices**



KEYPOINTS

After the gold standard was abandoned, it took some time for economists and policymakers to settle on the Federal Reserve's official objectives and the best way to accomplish them.

Keynesian and monetarist schools offered competing visions of what economic policy could achieve.

Learning from advancements in economic theory, the Federal Reserve has grown more practiced in conducting countercyclical monetary policy—smoothing out business-cycle fluctuations—to achieve its dual mandate of price stability and maximum employment.

The demise of the gold standard as the “North Star” for monetary policy created a vacuum: If the Federal Reserve no longer aimed to maintain a fixed exchange rate between the US dollar and gold, what should guide its monetary policy decisions?

The ideas behind the eventually formalized objectives of the Federal Reserve took shape in the 30 years after World War II. At the time, policymakers were rightly concerned that millions of soldiers were returning home with no job prospects, especially given that military production was set to decline sharply. In response, Congress passed the Employment Act of 1946, which called for all parts of the government—including the Federal Reserve—to pursue “maximum employment, production, and purchasing power.”

Keynesians vs. Monetarists

Despite these marching orders, it is fair to say that the Federal Reserve officials of that era did not visualize how they could contribute to maximum employment and production by any means other than promoting a stable currency. Soon, however, the budding Keynesian school of economics provided a vision that quickly gained adherents and influence.

Keynesian economics' impact was swift and profound. It taught that governments' monetary and fiscal policies could be designed to smooth out business-cycle fluctuations and promote full employment—without causing excessive inflation. Moreover, Keynesians de-emphasized the role of monetary policy in the inflation process.

Keynesian policies' newfound influence was evident in the 1960s. The government cut taxes and simultaneously stepped up spending on programs to address poverty and outfit the military. As a result, unemployment stayed low, while inflation gradually crept higher.

It is probably no coincidence that this period's relatively higher inflation coincided with the rise of an opposing school of thought: monetarism.

In monetarist economics, the Federal Reserve can control the money supply. In fact, growth in the money supply over time is the chief determinant of inflation. Monetarists warned that the unemployment rate consistent with maximum employment over time cannot be controlled through monetary policy, and that the Federal Reserve should be careful not to pursue an objective that was unattainable at best and counterproductive at worst.



In January 2012, the Federal Open Market Committee established an objective for stable prices of 2 percent inflation over the longer term. Inflation is one of the concepts explained and traced at the Federal Reserve Bank of Cleveland's Learning Center and Money Museum, shown above.

While neither theory as expressed in the 1960s is unconditionally embraced today, significant pieces of each endure. The insights provided by Keynesians and monetarists got policymakers asking the right questions and set the stage for some eventful decades of putting theory into practice.

The Dual Mandate

In the 1970s, the economy was hit by a sequence of energy and food supply shocks that weakened economic performance. The unemployment rate rose, and inflation accelerated dramatically. Congress grew more concerned that the Federal Reserve was not doing enough to manage economic performance. In 1978, the Full Employment and Balanced Growth Act, often called

the Humphrey-Hawkins Act in honor of its sponsors, specifically directed the Federal Reserve to “promote full employment . . . and reasonable price stability.”

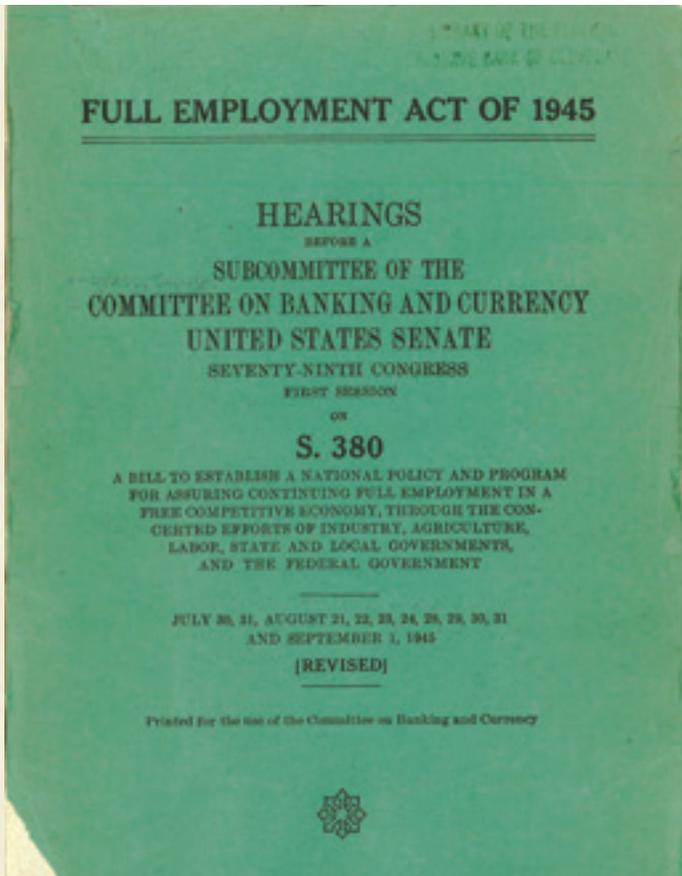
Although the Humphrey-Hawkins Act passed the House and Senate with considerable support, it was enacted amid an active debate among economists—not least the Keynesians and monetarists—and politicians about the relative importance and achievability of the employment and inflation objectives. Ever since, the Federal Reserve has been criticized at various times for paying either too much, or not enough, attention to one objective or the other.

During the 1980s, the Federal Reserve was understandably concerned with getting high and variable inflation under control. Chairman Paul Volcker argued in 1981 that the only viable path to achieving full employment was the path that first brought inflation down and convinced the public that it would stay down. In other words, the circumstances of the day required that inflation be dealt with as a precondition for achieving the dual mandate over the longer run.

As the 1980s progressed, theoretical developments in the design of monetary policy (discussed more fully in the next section of this essay) reinforced the idea that stabilizing inflation expectations is crucial to keeping the economy on its maximum-employment trajectory.

“Two ingredients seem to have been essential precursors of the Employment Act. The first was a deep concern that the problem of peacetime unemployment had not been solved. Although employment roared back during the war, the memory of the Great Depression was quite fresh, and considerable uncertainty attended the economic outlook. Put simply, many feared that the economy would slip back into depression. The second element was the economic thinking of John Maynard Keynes.”

Former Chairman Alan Greenspan, October 26, 2005



Early drafts of the Employment Act—such as this one from 1945—contained policy prescriptions that worked backward from estimates of full employment to specific numerical targets for investment and fiscal policy. In the end, the numerical targets were struck from the Act, and “full employment” became “maximum employment, production, and purchasing power.” It wasn’t until the 1987 Full Employment and Balanced Growth Act that the Federal Reserve was specifically directed to “promote full employment ... and reasonable price stability.”

“My view on the history of the Fed and the history of central banking is that there’s a lot of learning that takes place—institutional learning. You have certain preconceived notions which you inherited from the past, the Fed did, about what they were supposed to do. They were faced with a new reality. The Fed was set up in 1914—World War I came along ... The financial markets changed a lot from those of the nineteenth century. And again the Fed had to adjust to that. So there’s learning that takes place. The learning is never simple. It’s never linear. There’s always nonlinearities, there are mistakes that are made.” ►

Michael Bordo, Rutgers University

In 2012, the Federal Open Market Committee indicated it would continue its asset purchases until the outlook for labor market conditions has improved substantially in a context of price stability.

Economic performance improved in the 1980s and 1990s, in terms of both inflation and unemployment. During this period, operating under the formal guidance of the dual mandate, inflation gradually declined and became low and stable. The Federal Reserve became more practiced in conducting countercyclical monetary policy, or, put another way, smoothing out business-cycle fluctuations while keeping inflation in check.

2012 may well be judged one of the most action-packed, meaningful years in Federal Reserve history. But it was decades in the making.

Despite this solid record, the 2008 financial crisis renewed debate about the suitability of the Federal Reserve's dual mandate. Some ask whether the Federal Reserve has recently placed so much emphasis on its employment mandate that it has expanded its balance sheet to the point where high inflation is inevitable.

Federal Reserve officials are well aware of the risks and have moved to mitigate them. Encouraged both by the evolving academic results on the value of inflation targets and the experience of other central banks, the Federal

Open Market Committee (FOMC) took a historic step in January 2012: It formally pegged its long-run inflation objective at 2 percent. In the FOMC's own words, "Such clarity facilitates well-informed decisionmaking by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society."

Note that the statement reflected the long-standing academic and policy debate on the role of monetary policy and made explicit the shared understanding of the FOMC on these issues. In particular, the FOMC acknowledged that "the inflation rate over the longer run is primarily determined by monetary policy" but that "[t]he maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market."

Decisions Rooted in History

In this way, the Federal Reserve has synthesized insights from a long-running academic debate into a workable policy path. The FOMC's current estimate of the natural rate of unemployment is between 5.2 percent and 6 percent. Although the numerical estimate for full employment may be adjusted from time to time, the FOMC is just as committed to achieving it over the medium term as it is to satisfying its inflation objective. Experience in the United States and other countries strongly suggests that a full-employment objective need not compromise a central bank's ability to achieve price stability. In fact, as long as a nation's central bank can keep inflation expectations anchored, its citizens can benefit if monetary policy does what it can to keep the economy on its full-employment path.

By committing itself to achieving a set of numerical objectives for maximum employment and price stability, the FOMC has more clearly communicated to the public what it is trying to achieve. At the same time, by being so explicit, the FOMC has implicitly stepped up its accountability for achieving its objectives.

Add it all up, and 2012 may well be judged one of the most action-packed, meaningful years in Federal Reserve history. But it was decades in the making.