

# LESSONS



The ability of the Federal Reserve to accomplish its objectives in an increasingly complex environment will depend on its continued efforts to adapt, evolve, and learn.

Over the past century, the Federal Reserve's responsibilities have expanded and its policy tools have become more sophisticated. Its evolution mapped a progression in economic thinking, lessons from practical experience, and shifts in national economic goals. Some of the changes occurred gradually; others came with the sudden punch of crisis.

In its first years, the Federal Reserve's monetary and financial stability objectives and policy instruments were far more limited than today's.

The gold standard offered several advantages: It produced price stability over the very long run, and it minimized manipulation of the money supply if the government played by the "rules." However, during the lead-up to the Great Depression, some governments decided that staying on the gold standard required them to accept economic conditions they found intolerable. The Federal Reserve became responsible for ensuring stable purchasing power in a system tethered only to its own credibility. Needless to say, it took some time to figure out how to accomplish this goal.

Following World War II, the nation sought to do a better job at keeping the economy at full employment and smoothing the volatility inherent in business cycles; the Federal Reserve was expected to do its part. Using large-scale computer models of the economy, the Federal Reserve generated forecasts based on alternative policy choices, all with the goal of choosing the option most likely to produce both full employment and price stability.

The irony of the era was that the Federal Reserve's legal mandate was changed in 1978 to specify a "maximum employment" objective—just as inflation was spiraling out of control. Although some economic historians attribute that failure to the broadening of the legal mandate, an equally or more likely explanation is that the policymakers of the day simply—but disastrously—underestimated the degree of policy restraint required to keep inflation in check.

From this experience, the Federal Reserve learned the importance of designing policies that would keep inflation expectations anchored while it acted to counter business-cycle fluctuations. The rational expectations era was born. Many Federal Reserve officials recognized that monetary policy should no longer be considered a series of "point in time" decisions made under a cloak of secrecy, but rather an entire sequence of actions designed to accomplish objectives that were openly communicated to the public. More recently, the FOMC assigned numerical values to its long-run goal for price stability and its estimate for maximum employment in an effort to increase transparency and reduce uncertainty.

The roots of the Federal Reserve's involvement with banking supervision and regulation can be traced back to its founding. And, as with monetary policy, there has been significant evolution in the theory and practice of banking regulation. The financial crisis and deep recession of 2007–09 prompted Congress to significantly change the Federal Reserve's responsibilities and legal authority, including enhancing the goal of financial stability in the Federal Reserve's mission. One could argue that with the financial landscape quite changed since the 1910s, Congress was merely attempting to restore the Federal Reserve's ability to promote financial stability, as it did 100 years ago.

The arc of history suggests that it is far too soon to know how successful the Federal Reserve will be in meeting the nation's expectations for full employment, price stability, and financial stability. We still have a lot to learn about how to operate in this new environment, and unforeseen challenges will undoubtedly arise. As we have done from our founding, we are working with academics, industry professionals, and other central banks to learn from experience and stay abreast of the new theories and tools we will need to accomplish our objectives.

In the meantime, a healthy debate about the merits of Federal Reserve policy action continues, as is proper and necessary. We might also note that a little historical distance can produce insights not obvious in real time. So let's agree to check back in a decade or two; with the benefit of perspective, we can have an even better-informed discussion about how central banks can best contribute to economic prosperity. ■