The Great Escape: why the "dual mandate" is not enough

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Over the coming the years, I hope the Federal Reserve will have the courage to escape from the self-imposed constraints of the so-called "dual mandate".

Maximum employment and stable prices are – and should be – central, vital objectives for the Fed. On this there should be no doubt.

But is the tradeoff between unemployment and inflation a *complete* and *sufficient* guide for the choices the Fed makes in the conduct of monetary policy? Should full employment and price stability be understood as the Fed's *exclusive* objectives and the unemployment-inflation tradeoff as the Fed's *exclusive* constraints?

No. The Phillips curve is not a sufficient, not an adequate, expression of the tradeoffs and choices that the Fed needs to make and, in fact, does make.

It would be too easy for me simply to point out that the dual mandate view is *not* consistent with the Fed's *actual* statutory mandate from Congress, which directs the Fed to a broader set of issues and tradeoffs. I have a greater ambition. I want to persuade you that the Fed's actual statutory mandate is a better, more complete, more accurate and more thoughtful description of what we can and should expect of the Fed than the truncated, dual mandate.

Let me concede that the Phillips-curve-only view has certain virtues. It is based on the important, observed inverse relationship between the rates of unemployment and inflation. While we could debate its durability in the long run and the significance of its recent slope, ignoring the Phillips curve would be a mistake. Moreover, the rates of unemployment and inflation are, indeed, important goals of monetary policy, each telling us something about the pace of resource utilization. Given its apparent empirical basis, the unemployment-inflation tradeoff is straightforward to explain and, thus, makes communications about monetary policy so much simpler.

But if intended as a complete guide for monetary policy, the so-called dual mandate has a number of shortcomings.

First, the dual mandate view condenses too much, conflating "what" and "how". It presumes that unemployment and inflation represent the sole trade off and decision that Fed policy makers need to consider. The dual mandate view *collapses ends and means* – reducing both into a single policy choice between competing ends, leaving no room or expression for the means by which policy is to be carried out.

Second, the dual mandate view *ignores the role of credit*. Read a few paragraphs into most central bankers' speeches and you will soon find references to the importance of the credit channel and to whether credit growth is too slow, or too fast, or about right. It seems odd that there would be nothing about credit in the Fed's mandate.

Third, the claim that the unemployment-inflation tradeoff represents the Fed's sole objectives and constraints relegates *financial stability*, and the effective functioning of the financial system, to a secondary status. The dual mandate view suggests that financial stability is an unwanted and undesirable distraction from the important work of managing the Phillips curve.

Fourth, as presented, the dual mandate curiously has nothing to say about the *time horizon* at which the Fed's monetary policy should be aimed – a striking omission.

The Fed's actual mandate in Section 2A of the Federal Reserve Act (12 USC 225a) directly addresses each of these. Section 2A reads in full:

> *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.*

Note the clear distinction between the *mandate* and the *goals,* between *means* and *ends*.

The Fed's actual statutory *mandate*, the "shall" provision, the imperative, the thing the Fed must do and has no choice but to do, is to grow money and credit no faster and no slower than the economy's "long run potential to increase production" – our rate of productivity growth. The *mandate* specifies the necessary *means*, the "how" by which monetary policy is to be conducted.

The *ends* – the goals or objectives that the Fed is to promote in managing the growth of money and credit – are three, not two: maximum employment, stable prices and moderate long-term interest rates.

Credit and money, and the inter-temporal trade off of how much we borrow from our future, are central to the Fed's actual mandate. The Fed is instructed to grow credit and money at rates commensurate, or proportional, with the growth of productivity.

Credit and money growth that persistently exceed our productivity growth might cause aggregate demand to accelerate too much, contributing to inflationary pressures. A too-rapid growth of credit, divorced from the growth of real income, might also create unsustainable credit conditions contributing to financial instability and the deflationary pressures from falling asset prices. Rather than putting financial stability aside, the Fed's actual *mandate* integrates it by putting the rates of growth of credit and money at the center, where they serve as mandatory constraints on how the Fed is to pursue its three goals.

The Fed's actual statutory mandate is also specific about the appropriate time horizon. Section 2A clearly focuses the Fed's attention away from the short run (Phillips curve or otherwise) and towards the medium term and beyond, which is the only horizon over which we can sensibly think about calibrating the *long run* growth of credit and money with the economy's *long run* potential to increase production as *means* to the ultimate *ends* of maximum employment, stable prices and moderate long-term interest rates, *which must of necessity take place even further in the future.*

One can imagine objections to the Fed's actual mandate. One might worry that Section 2A requires a naïve or mechanistic monetarism. One might also think that a goal of "moderate" long-term interest rates is not consistent with how modern economists like to think.

I believe these worries are misplaced. (And, in any event, they should be addressed to Congress.)

The simple imperative that long run trends in the growth of money and credit should be commensurate with productivity reflects both micro-economic and macro-economic wisdom. It suggests that we should not lend someone more money than they are likely to be able to repay out of the real growth in their income – a prudent rule for any lender. It also suggests that, for the economy as a whole, we should symmetrically be sure *both* to borrow *enough* from our future so we can live up to our productive potential *and not* borrow *more* from our future than we can sustainably repay out of our likely collective gains in real income. While this will require difficult judgments in conditions of uncertainty, it is hardly a monetarist straightjacket.

Nor do I think it is irrational of Congress to suggest that one goal of monetary policy should be to have long-term interest rates deviate as little and as infrequently as possible from a moderate mean. This merely suggests that long-term interest rates should neither be too high nor too low for too long – unless necessary to ensure that the growth rates of money and credit are *both* consistent with productivity and in pursuit of the other goals of full employment and stable prices.

Some might argue that interest rates are simply too important a tool and, thus, the wrong tool, to constrain a too-rapid growth of credit. But this is a boot strap argument. It is only the self-imposed "dual mandate" itself that justifies reserving interest rates for managing the Phillips curve – and, by implication, leaving bank supervisors to make sure that credit conditions do not get too frothy and to clean up the mess when they do.

Of course we should use bank supervision and macro-prudential tools to *help* ensure the stability of the financial system. The question is whether *monetary* policy can wash its hands of this responsibility or whether, among its judgments, monetary policy should be called upon to modulate the rate of growth of credit and money.

Congress, at least, did not take the view in Section 2A that interest rates were somehow too important a tool to be used merely to influence the growth of credit.

A different objection is that the Fed's actual mandate is too difficult, that the Fed has only imprecise control over the growth of money and credit and that the rate of productivity growth is hard to know, perhaps impossible to know until after the fact.

Yes, monetary policy is difficult. But the outcomes are unlikely to improve by adopting the pretense of simplicity. What is easy to measure distracts us from what is important.

As I read it, the Fed's statutory mandate is an eloquent – even a noble – statement of what we can and should expect of our central bank: the Fed is directed to ensure that the rates of growth of credit and money neither constrain nor undermine the productive potential of the American people.

We should neither be constrained by insufficient credit growth and persistent deflation nor undermined by excessive credit growth and accelerating consumer-price or asset-price inflation.[1]

The Fed is *mandated* to *do no harm* to our ability to fulfill our productive potential with credit and money growth that is either too slow or too fast – relative to our best estimates of our long run productive potential.

Deep down, most central bankers understand that this is the essence of the job, reflecting the central importance of productivity.

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[1] Note that the Fed's actual mandate in Section 2A is not limited to consumer price inflation; the goal is "stable prices".

Credit and money growth are not a mere sideshow, they are the main event. There is a reason we call it *monetary* policy.

Congress did not tie the Fed's hands to consider only the tradeoff between unemployment and inflation. This is simply not so.

Looking under the street lamp of the Phillips Curve, and ignoring the growth of credit, was precisely the mistake the Fed made that contributed to the financial crisis and the loss of employment and output that followed ten years ago.

I am hopeful that Chairman Powell and his colleagues can avoid repeating this mistake. To do so, they will need to look beyond the Phillips curve and also to explain how their behavior is consistent with their mandate.[2]

I am rooting for the Fed to make a great escape from the blinders of the dual mandate to the more thoughtful, the more difficult, and the more important statutory mandate that Congress actually wrote.

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[2] Compare Chairman Powell's description of the Fed's objective function in his remarks "Monetary Policy at a Time of Uncertainty and Tight Labor Markets", at the ECB Forum on Central Banking, Sintra, Portugal, June 20, 2018 ("Achieving our statutory goal of maximum employment in a context of price and financial stability is both our responsibility and our challenge.") with the Phillips-curve-centric description in his remarks in "Monetary Policy and Risk Management at a Time of Low Inflation and Low Unemployment" at the 60th Annual Meeting of the National Association for Business Economics, Boston Massachusetts, October 2, 2018 (". . . the Federal Reserve's ongoing efforts to promote maximum employment and stable prices . . . our dual mandate,")