Changing the Federal Reserve's Mandate: An Economic Analysis

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Summary

The Federal Reserve's (Fed's) current statutory mandate calls for it to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Some economists have argued that the current mandate should be replaced with a single mandate of price stability. Often the proposal for a single mandate is paired with a more specific proposal that the Fed should adopt an inflation target. Under an inflation target, the goal of monetary policy would be to achieve an explicit, numerical target or range for some measure of price inflation. Inflation targets could be required by Congress or voluntarily adopted by the Fed as a way to pursue price stability, or a single mandate could be adopted without an inflation target. Alternatively, an inflation target could be adopted under the current mandate.

For at least the past two decades, bills have been introduced in Congress to switch the Fed's current mandate to a single mandate of price stability. In the 112th Congress, Representative Pence introduced H.R. 245, which would strike the goal of maximum employment from the mandate; it does not include an inflation target. Were a single mandate to be adopted in the United States, it would follow an international trend that has seen many foreign central banks adopt single mandates or inflation targets in recent decades.

Arguments made in favor of a price stability mandate are that it would better ensure that inflation was low and stable; increase predictability of monetary policy for financial markets; narrow the potential to pursue monetary policies with short-term political benefits but long-term costs; remove statutory goals that the Fed has no control over in the long run; limit policy discretion; and increase transparency, oversight, accountability, and credibility. Defenders of the current mandate argue that the Fed has already delivered low and stable inflation for the past two decades, unemployment is a valid statutory goal since it is influenced by monetary policy in the short run, and discretion is desirable to respond to unforeseen economic shocks. A case could also be made that changing the mandate alone would not significantly alter policymaking, because Fed discretion, transparency, oversight, and credibility are mostly influenced by other factors, such as the Fed's political independence.

Discontent with the Fed's performance in recent years has led to calls for legislative change. It is not clear that a single mandate would have altered its performance, however. Some of the criticisms, including lax regulation of banks and mortgages and "bailouts" of "too big to fail" firms, were authorized by statute unrelated to the Fed's monetary policy mandate. The criticism that the Fed was responsible for the depth and length of the recession leads to the prescription that monetary policy should have been more stimulative; it does not follow that more stimulus would have been pursued under a single mandate. Whether or not the Fed allowed the housing bubble to inflate, it is not clear that a single mandate would have changed matters since the housing bubble did not result in indisputably higher inflation. Some economists believe that the Fed's recent policy of "quantitative easing" (large-scale asset purchases) will result in high inflation. Since inflation has not increased to date, a single mandate would not have prevented quantitative easing. The Fed has discretion to pursue policies it believes are consistent with its mandate, and it has argued that quantitative easing was necessary to avoid price deflation. It could still make this argument under a single mandate.

This report discusses a number of implementation issues surrounding an inflation target. These include what rate of inflation to target, what inflation measure to use, whether to set a point target or range, and what penalties to impose if a target is missed.

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Introduction

The recent financial crisis and deep economic recession have led to criticisms of the Federal Reserve's (Fed's) handling of both. Critics have blamed the Fed for pursuing policies that allowed the housing bubble to inflate, for lax regulation of financial firms and mortgage markets that led to excessive speculation, for "bailing out" financial firms during the crisis, for failing to prevent the recession's unusual length and depth, and for engaging in "quantitative easing" that critics believe will result in high inflation. Although alternative explanations have also been offered for each of these criticisms, they have led some Members of Congress to question whether legislative remedies are needed to avoid similar problems in the future. In particular, some Members of Congress have argued that the Fed's statutory mandate should be modified.

The Fed's statutory mandate was set in the "Federal Reserve Reform Act of 1977."[1] It currently reads:

> 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.[2]

Although this mandate includes three goals, it is often referred to by economists as a "dual mandate" of maximum employment and stable prices. Some economists have argued that Congress should strike the goals of maximum employment and moderate long-term interest rates from the current mandate, leaving price stability as the only mandated goal. Often the proposal for a single mandate is paired with a more specific proposal that the Fed should adopt an inflation target. Under an inflation target, the goal of monetary policy would aim to achieve a predefined numerical target or range for some measure of inflation (the change in the general price level).

For at least the past two decades, bills have been introduced in Congress to switch the Federal Reserve to a single mandate of price stability. In the 112th Congress, Representative Pence introduced H.R. 245 that would change the Fed's mandate to a single mandate of price stability; it does not include an inflation target. Were a single mandate to be adopted in the United States, it would follow an international trend that has seen many foreign central banks, including those of New Zealand, Canada, Australia, and the United Kingdom, adopt price stability mandates, inflation targets, or both in recent decades.

This report analyzes the economic arguments for and against shifting to a single mandate. It then analyzes possible effects of a mandate change on Fed policymaking in the context of recent criticisms related to the Fed's performance. It also discusses the advantages and disadvantages of different options for implementing an inflation target.

[1] P.L. 95-188, 91 Stat. 1387.

[2] Section 2A of the Federal Reserve Act, 12 USC 225a. This language was previously included in House Concurrent Resolution 133 of 1975.

Background on Monetary Policy

Congress has delegated monetary policy responsibilities to the Fed, and requires the Fed to set monetary policy to achieve its mandated goals. In normal circumstances, the Fed implements monetary policy by setting a target for the federal funds rate, the overnight inter-bank lending rate. (During the recent financial crisis, the Fed has taken several unconventional steps to stimulate economic activity besides changes in the federal funds target.[3]) Generally, if the Fed wishes to moderate the growth in economic output and inflationary pressures, it "tightens" or "contracts" policy by raising the federal funds target. If it wishes to stimulate the growth in economic output and inflationary pressures, it "loosens" or "expands" policy by reducing the federal funds rate.

Congress has given the Fed broad day-to-day discretion to choose the federal funds rate target that the Fed believes is compatible with its statutory goals. Congress retains oversight responsibilities, and those responsibilities are primarily exercised through Congressional hearings, including mandated semi-annual hearings in which the committees of jurisdiction receive a written report and testimony from the Chairman of the Fed. If Congress finds the Fed's pursuit of its statutory goals to be lacking, however, it has limited "carrots" or "sticks" available to induce a change in behavior. A fundamental problem with holding the Fed accountable for its performance is that it has a limited influence over economic outcomes. When the actual performance of the economy deviates from the mandated goals, the Fed can make the case, with some justification, that those deviations were caused by factors outside of its control.

Monetary policy is only one of the Fed's main responsibilities. Other responsibilities—including lender of last resort functions in a crisis and supervision of banks and the payment system—are laid out in other sections of the Federal Reserve Act and other parts of federal statute. Changing the Fed's monetary policy mandate alone would not alter the authorities governing the Fed's other responsibilities.

The Relationship Between Inflation Targeting and the Mandate

The statutory mandate sets the ultimate goals of monetary policy, and can be altered only through legislative action. The instruments, methods, and strategies that the Fed employs to reach those goals is not laid out in law. Inflation targeting can be thought of as a strategy for achieving mandated goals—direct policy at achieving a numerical target for inflation. Because it is a strategy for achieving statutory goals, it could be codified through legislation or adopted internally by the Fed.

Traditionally, proponents of a single mandate and inflation targeting have been one and the same. There is logic to the idea that if the Fed's sole focus of policy is going to be achieving price stability, then there should be a numerical target to help ensure that goal is achieved and facilitate evaluation of the Fed's performance in relation to the mandate. Legislation could include both,

[3] For more information, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

but need not. One might favor a single mandate of price stability, but oppose a legislated inflation target on the grounds that the Fed should have maximum independence and flexibility to pursue that mandate. Or Congress might legislate a single mandate, and the Fed could then choose whether to voluntarily adopt an inflation target to help meet the single mandate.

Although many proponents of inflation targeting also favor a single mandate, an inflation target could also be adopted without changing the current mandate. Fed Chairman Ben Bernanke was a well-known advocate of inflation targeting before his time at the Fed, but has repeatedly defended the dual mandate in its current form while at the Fed. He has suggested that an inflation target would be complementary to the dual mandate. In 2005, he testified:

> One possible step toward greater transparency would be for the FOMC to state explicitly the numerical inflation rate or range of inflation rates it considers to be consistent with the goal of long- term price stability, a practice currently employed by many of the world's central banks. I have supported this idea in my academic writings and in speeches as a board member. Providing quantitative guidance about the meaning of "long-term price stability" could have several advantages, including further reducing public uncertainty about monetary policy and anchoring long-term inflation expectations even more effectively. I view the explicit statement of a long-run inflation objective as fully consistent with the Federal Reserve's current policy approach, including its appropriate emphasis on the role of judgment and flexibility in policymaking. Most important, this step would in no way reduce the importance of maximum employment as a policy goal. Indeed, a key justification for this action is its potential to contribute to stronger and more stable employment growth by further stabilizing inflation and inflation expectations.[4]

Although it is debatable whether an inflation target is compatible with the equal weighting of maximum employment and price stability in the dual mandate, given the Fed's broad discretion over policy implementation, the Fed would not need to seek new authority or wait for a mandate change to adopt an inflation target if it desired.

Evaluating the Rationales for a Single Mandate of Price Stability

Proponents claim that a series of related benefits would stem from a single mandate of price stability. These claims have been criticized on two grounds—that purported benefits would actually result in worse policy and economic outcomes than the status quo, or that the Fed, in practice, has already delivered the same benefits under the current dual mandate. In fact, some economists have referred to the Fed as an "implicit inflation targeter" because of the latter argument.[5] This section considers each of those arguments in turn.[6]

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[4] Ben Bernanke, Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, November 15, 2005.

[5] See, for example, Marvin Goodfriend, "Inflation Targeting in the United States?", in Ben Bernanke and Michael Woodford, eds., *The Inflation Targeting Debate* (Chicago: University of Chicago Press, 2004), ch. 8. The Federal Open Market Committee (FOMC), the internal Fed committee that sets monetary policy, already publishes a "longer run" forecast for inflation. Since monetary policy is the primary determinant of inflation in the longer run, this could be seen as the FOMC's implicit inflation target.

[6] This section draws on Ben Bernanke and Michael Woodford, eds., *The Inflation Targeting Debate*, University of Chicago Press, (Chicago: 2004); Ben S. Bernanke et al., *Inflation Targeting* (Princeton: Princeton University Press, (continued...)

For clarity of discussion, this report will treat a single mandate and inflation targeting as complementary when evaluating the merits and drawbacks of the proposal unless otherwise noted. In other words, an inflation target would increase the benefits and drawbacks of changing the mandate. It should be noted, however, that more of the literature has focused on inflation targeting than on a single mandate, so certain authors may not necessarily have intended their arguments to be applied to both.

The Level and Stability of Price Inflation

A long-standing critique of macroeconomic policymakers is that they inappropriately choose the short-term political benefits of low unemployment over the long-term costs of higher inflation. Election-minded policymakers allegedly have a bias toward overly stimulative policy in an effort to "rev up" the economy beyond its sustainable limits that ultimately results in undesirably high inflation beyond their political horizons. While the dual mandate already calls for stable prices, its inclusion of maximum employment could potentially allow policymakers to justify this bias. Proponents of a single mandate claim that it would reduce the scope for policymakers to indulge in that bias, and would therefore result in lower and more stable inflation over time.

Two questions can be answered with empirical evidence to help evaluate the legitimacy of this argument. First, has the Fed consistently delivered price stability under a dual mandate? Second, have other countries with single mandates or inflation targets delivered low and stable inflation more consistently than the Fed?

Although inflation was high in the 1970s and parts of the 1980s, it has been consistently low and stable, as measured by the consumer price index (CPI), over the past two decades. The increase in the overall CPI has been below 4% for the year in each year since 1991.[7] In its policymaking, the Fed has preferred to focus on core inflation, which omits food and energy prices. Using the Fed's preferred measure, the core CPI has been above 1% and below 3% each year since 1995 and has not shown any tendency to rise at the end of the past two business cycles. In other words, the Fed has been highly successful at achieving price stability by its preferred measure for 15 years, and almost as successful by a broader measure of inflation.[8] (House prices are not included in any of the common measures of price inflation, so the rapid increase in house prices in the 2000s had no direct effect on inflation.)

(...continued)

1999); Edwin Truman, *Inflation Targeting*, Institute for International Economics, October 2003; Michael Dueker and Andreas Fischer, "Do Inflation Targeters Outperform Non-Targeters?," *Federal Reserve Bank of St. Louis Review*, September 2006, p. 431; Manfred Neumann and Jurgen von Hagen, "Does Inflation Targeting Matter?", Federal Reserve Bank of St. Louis, *Review*, July 2002, p. 127; Benjamin M. Friedman, Kenneth N. Kuttner, Mark Gertler, James Tobin, "A Price Target for U.S. Monetary Policy? Lessons from the Experience with Money Growth Targets," *Brookings Papers on Economic Activity*, Vol. 1996, No. 1, 1996, p. 77; William McDonough, "A Framework for the Pursuit of Price Stability," *Economic Policy Review*, vol. 3, no. 3 (August 1997), p. 1; Andrew Levin, Fabio Natalucci, Jeremy Piger, "The Macroeconomic Effects of Inflation Targeting," *Federal Reserve Bank of St. Louis Review*, July/Aug. 2004, p. 51; Richard Dennis, "Inflation Targeting Under Commitment and Discretion," *Federal Reserve Bank of San Francisco Economic Review*, 2005, p. 1.

[7] In 2009, the CPI experienced slight deflation, meaning overall prices fell. In this case, inflation was lower than desired. In other words, the one time in recent years it failed to achieve price stability, it was the opposite problem of the one predicted by the economic theory that policymakers are biased toward high inflation.

[8] Similar results are found using other price indices, such as the gross domestic product (GDP) deflator or the PCE (personal consumption expenditures) deflator.

Some economists believe that the Fed has pursued policies since the financial crisis that are incompatible with price stability, but those unconventional policies have not, to date, resulted in any tangible increase in inflation.[9] The Fed, for its part, has argued that those policies are necessary for price stability, in order to avoid price deflation.

Further, the Fed's inflation record is not significantly different from that of major inflation targeters.[10] For example, from 2000 to 2010, average inflation in the United States was within one percentage point of the average for major inflation targeters, with inflation in Australia and New Zealand slightly higher than the United States, and inflation in the Euro Area, United Kingdom, and Canada slightly lower.[11]

There has been some dispute among economists as to whether overall inflation or a core measure is a more appropriate benchmark for evaluating the Fed's performance.[12] But in the context of changing the mandate, two points can be made. First, the Fed's record on price stability by its preferred measure over the last 15 years could not have been improved upon under an alternate mandate or an inflation target. Second, its record is not quite as good by other measures. But if one believes that the Fed is defining price stability incorrectly (e.g., it should use overall inflation instead of core inflation, or it should include house prices in its inflation measure), one would have to explicitly add that to a mandate change or inflation target. Otherwise, the Fed would have discretion to define price stability in terms of whatever measure it prefers.

The Fed's record on inflation may be good, contrary to the predicted policy bias, because the Fed's independence may already be sufficient to allow it to effectively ignore short-term benefits of higher inflation. In other words, a mandate change is not necessary for the Fed to resist the temptation to pursue policies with short-term benefits and long-term costs.

The Long-Run Neutrality of Money on Employment

A central tenet of mainstream economic theory is that money is neutral in the long run, meaning that changes in monetary policy do not have permanent effects on the level of employment. In the long run, it is primarily labor market policy that influences the "natural rate" of unemployment, and the Fed has no control over labor market policy.[13] (The mandate's call for "maximum employment" is typically interpreted to mean keeping unemployment near its natural rate, as opposed to, say, reducing unemployment to zero.)

Proponents of a mandate change argue that the Fed's mandate should not include a variable that the Fed cannot control in the long run. Further, some economists have argued that the best way

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[9] This issue is discussed in depth in the section entitled "Quantitative Easing."

[10] See Michael Dueker and Andreas Fischer, "Do Inflation Targeters Outperform Non-Targeters?", Federal Reserve Bank of St. Louis, *Review*, vol. 88, no. 5, September/October 2006, p. 431.

[11] CRS calculations based on data from the International Monetary Fund, World Economic Outlook database, October 2010.

[12] For more information, see CRS Report RS22705, *Inflation: Core vs. Headline*, by Marc Labonte.

[13] The theory of a natural rate of unemployment posits that the economy will tend toward an equilibrium unemployment rate in the long run. When unemployment is at this "natural rate," inflation will neither rise nor fall. For more information, see CRS Report RL30391, *Inflation and Unemployment: What is the Connection?*, by Brian W. Cashell.

for the Fed to contribute to economic efficiency in the long run is by keeping prices stable.[14] Price stability reduces errors made by economic agents because of mistaken forecasts about future price movements, and reduces "shoe leather" costs caused by the expense and effort of individuals to protect themselves against inflation.[15]

While a belief that monetary policy has no long-term effect on employment may be fairly uncontroversial, it is also uncontroversial to assert that monetary policy has a significant effect on the business cycle, which is the main driver of total employment and unemployment in the short run. It can take several years for the economy to return to full employment after a downturn, and the economy rarely remains at full employment for long. In economist Olivier Blanchard's view, "while money is eventually neutral…monetary policy can affect the real interest rate for a decade and perhaps more…[and] output or unemployment, for a roughly equal time…"[16] Thus, as a practical matter, the effect of monetary policy on employment is always a relevant policy concern. Foreign central banks with single mandates have proven to still adjust monetary policy in response to changes in employment, in practice.

Some would also question the mainstream premise that monetary policy has no long-term effect on employment. A central tenet to the natural rate of unemployment concept is that the natural rate is unaffected by the business cycle. There is a theory, called "hysteresis," that prolonged periods of high unemployment raise the natural rate of unemployment. This could occur, for example, because a worker's skills are eroded by episodes of long-term unemployment, making the individual less employable when the economy recovers. If the hysteresis argument is correct, monetary policy could influence employment in the long run. For example, an aggressively stimulative monetary policy could prevent hysteresis by limiting long-term unemployment following a deep recession. Such a policy might be more aggressive than what would be called for solely on the basis of maintaining price stability. Policymakers would have to decide where to draw the line in the tradeoff between combating hysteresis and maintaining price stability, but this is in contrast with the neutrality of money argument that there is no long-term tradeoff.

Stagflation: The Proper Response When Mandated Goals Diverge

One criticism of the dual mandate is that the Fed has multiple goals, but only one instrument (open market operations) to pursue those goals. When goals conflict, the mandate offers no guidance as to which goal takes precedence.

Most of the time, employment and inflation move together. During economic downturns, employment and inflation both decline; during booms, they both rise. In those cases, the policy prescription is likely to be the same—expansionary in a boom and contractionary in a downturn—under a single or dual mandate. For example, the Fed is currently concerned that employment and inflation are too low—in these circumstances, both a single or dual mandate would call for expansionary policy. Further, movements in employment are seen as leading indicators of future movements in inflation. If that is the case, monetary policy would respond to movements in employment even if policymakers were only concerned with price stability. It

[14] See, for example, Chairman Ben Bernanke, "The Benefits of Price Stability," speech at the Center for Economic Policy Studies, Princeton University, Princeton, New Jersey, February 24, 2006.

[15] "Shoe leather costs" refer to the example that if individuals have to make frequent trips to the bank to prevent inflation from eroding the value of their currency, the leather in their shoes will wear out faster.

[16] Olivier Blanchard, "Remarks at the New School," November 2002, http://econ-www.mit.edu/files/731.

follows that, in normal circumstances, policy reactions to changes in employment would be similar under a single or dual mandate.

There are cases when employment and inflation do not move together, however. For example, "supply shocks," such as a sharp increase in the price of oil, would temporarily reduce economic activity while temporarily increasing inflation. The most famous case is the "stagflation" of the 1970s, when the recessions beginning in 1973 and 1979 both involved rising inflation and falling employment. High inflation persisted throughout the 1970s and was not wrung out of the system until a second, deeper recession occurred beginning in 1981. If stagflation occurred, tighter or easier monetary policy would be consistent with the dual mandate, whereas the single mandate would call for neutral or tighter policy (if the supply shock caused all prices to begin rising more rapidly). For many economists who have supported a single mandate, the poor performance of the 1970s is the main argument in favor of changing the mandate (although the dual mandate was not adopted until 1978). The argument against easing policy during stagflation would be that, if one accepts the premise that monetary policy has no long-term effects on employment, the efficiency gains of price stability outweigh the short-term costs of temporarily higher unemployment. While that may be the case, to some policymakers, the long-term benefits of lower inflation would not outweigh the short-term costs of high unemployment.

Transparency and Discretion

Proponents of a single mandate argue that it would improve monetary policy by reducing the Fed's policymaking discretion. The result of a broad mandate, they argue, is that the Fed does not have to offer any systematic rationale for its policy decisions, and can therefore pursue any policy direction it desires. Sometimes monetary policy is criticized for excessive "fine tuning," meaning the adjustment of policy to every small economic development, which some economists believe is in itself destabilizing. It is argued that a more hands-off approach would reduce the volatility in economic growth and prices.

Discretion, they argue, also reduces transparency, meaning, in this context, the ability of market participants to predict and comprehend the rationale of monetary policy changes. A better understanding of monetary policy makes it more effective, it is argued, by improving the accuracy and ability of the private sector's economic planning. An inflation target, for example, might make it clearer to market participants what the Fed's plans were and what goals it was trying to accomplish. Proponents do not claim that the Fed would lose all discretion under a single mandate, but have sometimes described inflation targeting as "constrained discretion."[17]

Other economists argue that maximum discretion is necessary and desirable because short-term economic performance is dominated by unforeseen shocks, and it is these shocks, rather than policy mistakes, that are the root cause of economic volatility. Were policymakers not free to rapidly respond to those shocks, they believe, downturns would be deeper and more frequent. Since these shocks affect recorded inflation with a long lag, if policymakers felt compelled under a single mandate or inflation target to wait until prices had changed to respond, then the response could be undesirably late. For example, inflation (as measured by the CPI) in 2008 rose 3.8%, which was its highest rate since 1991. If the Fed had felt compelled to focus policy solely on the inflation rate, it might have felt constrained in its response to the financial crisis that occurred that

[17] Ben Bernanke and Frederic Mishkin, "Inflation Targeting: A New Framework for Monetary Policy?," *Journal of Economic Perspectives*, vol. 11, no. 2, Spring 1997, p. 97.

year. Flexibility allowed the Fed to introduce multiple innovative and unconventional policies to respond to problems in financial markets as they arose during the crisis.

An alternative perspective is that a single mandate alone would do little to curb the Fed's discretion because its discretion flows mainly from other sources, primarily the Fed's high degree of independence from Congress and Congress's long-standing custom of not involving itself in the Fed's day-to-day policymaking decisions. There is no outside arbiter to deem whether the Fed's decisions are consistent with its mandate now, and that would still be the case if the mandate were changed in isolation. In this light, the Fed's discretionary powers would not be significantly affected by a change in the mandate, but could be affected by other provisions that accompany a mandate change in legislation. For example, an inflation target could reduce the Fed's discretion by reducing the scope for policy options that would cause inflation to miss its target, although the extent that a target would reduce discretion depends greatly on the design of the target, as discussed below. But even the breaching of an inflation target would not trigger any automatic change in policy, as they have operated in other countries.[18]

An argument could also be made that a single mandate would not greatly alter the Fed's transparency, in the sense of the term as used in this section, because the Fed is already highly transparent. It releases quarterly economic forecasts. Minutes of Federal Open Market Committee meetings are released with a lag. Typically, changes in interest rates and other policy decisions are well predicted and expected by market participants before they occur. Transparency flows primarily from the Fed's communication style—major policy changes are typically hinted at and debated in speeches, interviews, or articles by Fed officials before they are announced. Since current transparency practices are largely voluntary, they may be unaffected by a mandate change.

Oversight and Accountability

A criticism of the current mandate has been that the multiple statutory goals are so broad and wide-ranging that they can be used to justify virtually any policy decision. Critics say that this makes effective Congressional oversight difficult, and makes the Fed unaccountable for policy mistakes. Oversight and accountability would improve under a single mandate, according to proponents, because it would make it easier to evaluate the Fed's performance, particularly if the single mandate included an inflation target.

Congress has considerable scope to alter the degree of accountability that is unrelated to the mandate, however. For example, it controls the number of hearings and Government Accountability Office audits on Federal Reserve issues, as well as the number of reports that it requires the Fed to produce for it. Accountability may be hampered mainly by two other factors that a single mandate does not address.

First, the functioning of the economy is complex, and Congress may lack the specialization to independently assess the Fed's performance. For example, the Fed does not typically refer to its dual mandate to justify bad economic outcomes—it blames them on factors outside its control. Since the Fed's influence on the economy is limited, it is certainly the case that many of the

[18] A paper from the San Francisco Fed uses simulations to demonstrate that an inflation target where discretionary changes are allowed would have led to monetary policy since the 1980s that is fairly close to the actual policy that the Fed pursued. Richard Dennis, "Inflation Targeting Under Commitment and Discretion," *Federal Reserve Bank of San Francisco Economic Review*, 2005, p. 1.

negative shocks that influence the economy could not be prevented by the Fed. But for effective accountability, Congress must be able to effectively determine whether bad economic outcomes (such as missing an inflation target) are caused by the Fed or beyond the Fed's control.

Second, there are many institutional factors that make the Fed less accountable than a typical executive branch agency. There are no statutory or institutional consequences for missing the mandated goals; nor is there any formal process for identifying when the goals have been missed. The Fed's officials do not answer to the President. Fed governors are appointed to long, overlapping terms. The Fed is self-funded and is not subject to the appropriation process or any other form of regular Congressional budgetary review. By statute, the Government Accountability Office cannot perform monetary policy evaluations of the Fed. There are statutory barriers to its interaction with the executive branch—for example, it cannot purchase federal debt directly from the Treasury. While all of these factors make the Fed less accountable, they also make the Fed more independent from Congress. Many economists have argued that this independence is desirable because it is responsible for the Fed's overall record of good policymaking.

Credibility

Another argument made in favor of a single mandate is that it will enhance the Fed's credibility, and monetary policy is more effective under credible central banks. In a well-known paper, economist Kenneth Rogoff argued that if a central bank has a reputation of being tough on inflation, then when the central bank eases policy, it will be more effective than if the central bank lacked credibility.[19] This phenomenon can be illustrated by looking at monetary policy's effect on interest rates across the yield curve. Stimulative monetary policy involves reducing short-term interest rates, but economic activity may be more responsive to changes in long-term interest rates. If a central bank lacking credibility reduces interest rates, markets may believe that it will lead to high inflation in the future, which could prevent long-term interest rates from falling. But when a credible central bank reduces short-term rates, long-term rates could follow since there are less fears of inflation.

There does not appear to be compelling evidence at this time that the Fed suffers from a lack of credibility with market participants. Inflation expectations are low despite the fact that the Fed is currently pursuing an unconventional policy that, under normal circumstances, would be inconsistent with price stability. Long-term interest rates are at low levels by historical standards. Foreigners continue to be willing to hold U.S. assets. Thus, the Fed may gain little additional credibility from a switch to a single mandate.

Recent Criticisms of the Fed's Performance: Would a Single Mandate Have Resulted in Better Outcomes?

Since the financial crisis began, the Fed has been subject to significant criticism on a number of different fronts. Some would argue that its shortcomings of the past few years are a sign that

[19] Kenneth Rogoff, "The Optimal Degree of Commitment to an Intermediate Monetary Target," *Quarterly Journal of Economics*, vol. 100, no. 4, November 1985, p. 1169.

legislative action is needed to improve its performance. This section analyzes whether a switch to a single mandate might have altered the criticized policy decisions.

The Length and Depth of the Recession

The Fed has been criticized for not preventing the last recession from becoming the longest and deepest recession since the Great Depression. In this sense, the Fed failed to fulfill its dual mandate, although economists are divided about how much factors beyond the Fed's control are to blame. What is difficult to dispute is that beginning in August 2007—months before the recession officially began—the Fed undertook a series of aggressive steps to stimulate the economy and provide liquidity to the financial sector. These steps were innovative and unconventional, and included reducing short-term interest rates to nearly zero, creating a series of unprecedented lending facilities, and conducting "quantitative easing" (large-scale purchases of securities, including mortgage-backed securities).[20] While there has been criticism of the long-term implications of some of these policy steps, it is difficult to argue that the Fed was too passive in responding to the recession. For critics of unconventional policy, constraint would have been desirable from a long-term perspective, but in the short run, a less aggressive policy would have resulted in less monetary stimulus, and probably a deeper and longer recession.

Further, it is not clear how the Fed would have acted differently under a single mandate or an inflation target. The Fed's unconventional policy initiatives were not required to be justified in terms of its mandate. It can be argued that many of these initiatives were undertaken under the Fed's lender of last resort duties, which are not contained within its mandate.[21] Several initiatives relied on the Fed's emergency lending powers, which are found in a separate part of the Federal Reserve Act, Section 13(3). Perhaps the Fed would have felt constrained to act less aggressively during the crisis if inflation had been above its target, although the Fed might have justified its actions by arguing that the crisis made deflation a greater threat than inflation.

The Housing Bubble

A separate criticism is that the underlying cause of the recession was the growth and subsequent bursting of the housing bubble, which led to crippling losses in the financial sector that eventually led to panic. Some critics have argued that the Fed should have prevented the housing bubble from inflating in the first place; if it had done so, then the bursting of the bubble would not have been so damaging to the financial system and economy. These critics argue that the Fed left stimulative monetary policy in place for too long after the 2001 recession, and the resulting low mortgage rates helped inflate the bubble. For example, the federal funds target was 2% or less until December 2004, three years after the recession had ended. These critics argue that the Fed should have raised interest rates to cool down the housing market when house prices started to accelerate.[22]

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[20] For more information, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

[21] In light of its role in the financial crisis, another potential legislative change would be to add lender of last resort duties or a goal of financial stability to the Fed's monetary policy mandate, since these duties are not explicitly enumerated elsewhere in the Federal Reserve Act.

[22] Another argument is that if the Fed had done a better job of regulating mortgage products a housing bubble could have been avoided. This argument is considered in the section below entitled "Lax Supervision of the Financial System (continued...)

Chairman Bernanke has argued that

> Even if monetary policy was not a principal cause of the housing bubble, some have argued that the Fed could have stopped the bubble at an earlier stage by more-aggressive interest rate increases. For several reasons, this was not a practical policy option. First, in 2003 or so, when the policy rate was at its lowest level, there was little agreement about whether the increase in housing prices was a bubble or not (or, a popular hypothesis, that there was a bubble but that it was restricted to certain parts of the country). Second, and more important, monetary policy is a blunt tool; raising the general level of interest rates to manage a single asset price would undoubtedly have had large side effects on other assets and sectors of the economy. In this case, to significantly affect monthly payments and other measures of housing affordability, the FOMC likely would have had to increase interest rates quite sharply, at a time when the recovery was viewed as "jobless" and deflation was perceived as a threat.[23]

For the purposes of this report, it is not necessary to settle the debate about whether the Fed should be blamed for the housing bubble. Rather, the relevant question is whether a single mandate or inflation target would have led the Fed to tighten policy sooner to avoid a bubble. Quotes from Chairman Bernanke suggest that this is unlikely. Chairman Bernanke has stated that, even in hindsight, "…monetary policy from 2002 to 2006 appears to have been reasonably consistent with the Federal Reserve's mandated goals of maximum sustainable employment and price stability…"[24] He has also said, before the financial crisis, that

> …to the extent that a stock-market boom causes, or simply forecasts, sharply higher spending on consumer goods and new capital, it may indicate incipient inflationary pressures. Policy tightening might therefore be called for—but to contain the incipient inflation not to arrest the stock-market boom per se.[25]

Neither the dot-com bubble nor the housing bubble was manifested in high overall price inflation, so a single mandate is unlikely to have made the Fed more responsive to those bubbles than the dual mandate.

Asset bubbles are likely to continue to be a policy concern in the future. If policymakers believe the Fed should be more responsive to future asset bubbles, they could instead expand the mandate to require that the Fed prevent asset bubbles or, more generally, ensure financial stability.[26]

(...continued)

and Mortgage Markets."

[23] Chairman Ben S. Bernanke, "Causes of the Recent Financial and Economic Crisis," Testimony before the Financial Crisis Inquiry Commission, Washington, D.C., September 2, 2010.

[24] Chairman Ben S. Bernanke, "Monetary Policy and the Housing Bubble," Speech at the Annual Meeting of the American Economic Association, Atlanta, Georgia, January 3, 2010.

[25] Ben Bernanke, "Asset Price 'Bubbles' and Monetary Policy," Speech before the National Association of Business Economics, New York, NY, October 15, 2002.

[26] The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) created the Financial Stability Oversight Council (FSOC) to identify risks to financial stability, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. The Chairman of the Federal Reserve is a member of the FSOC. Including financial stability in the Fed's mandate could be seen as either complementary or inconsistent with the FSOC.

Quantitative Easing

Some economists have criticized the Fed's decision to pursue "quantitative easing" (expansion in the Fed's balance sheet through large-scale asset purchases)[27] on the grounds that it will lead to high inflation.[28] In normal conditions, extended quantitative easing would be inconsistent with price stability, but the Fed believes that because of problems in the economy and financial markets, quantitative easing is needed for a timely economic recovery and to reduce the threat of deflation. The Fed also believes that quantitative easing will support mortgage markets and assist a recovery in the housing market.

The link between quantitative easing and price stability is clearer than the link between the other recent criticisms of the Fed. Nevertheless, as long as the Fed is given discretion to pursue policies that it believes are consistent with price stability, it seems doubtful that a single mandate would have prevented the Fed from pursuing price stability. This can be demonstrated by examining the following FOMC statement announcing the first round of large-scale asset purchases:

> In light of increasing economic slack here and abroad, the Committee expects that inflation will remain subdued. Moreover, the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term.
>
> In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability…. To provide greater support to mortgage lending and housing markets, the Committee decided today to increase the size of the Federal Reserve's balance sheet further by purchasing up to an additional $750 billion of agency mortgage-backed securities, bringing its total purchases of these securities to up to $1.25 trillion this year, and to increase its purchases of agency debt this year by up to $100 billion to a total of up to $200 billion. Moreover, to help improve conditions in private credit markets, the Committee decided to purchase up to $300 billion of longer-term Treasury securities over the next six months.[29]

Similarly, the November 2010 FOMC announcement of another round of asset purchases, popularly coined "quantitative easing 2," reads:

> To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to expand its holdings of securities…. the Committee intends to purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about $75 billion per month. The Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability.[30]

In both of these announcements, the Fed justified its decisions in terms of the need to avoid deflation in order to achieve price stability under the dual mandate. Switching to a single mandate

[27] For more information, see CRS Report R41540, *Quantitative Easing and the Growth in the Federal Reserve's Balance Sheet*, by Marc Labonte.

[28] See, for example, "An Open Letter to Ben Bernanke," November 15, 2010, downloaded at http://economics21.org/commentary/e21s-open-letter-ben-bernanke.

[29] Federal Open Market Committee, press release, March 18, 2009.

[30] Federal Open Market Committee, press release, November 3, 2010.

would presumably not change the Fed's belief that quantitative easing is necessary to maintain price stability.

A related fear raised by some is that the Fed is "monetizing the federal debt" through quantitative easing, meaning that the Fed is financing the government's budget deficits. Direct purchase of the debt from the Treasury by the Fed is already forbidden under Section 14 of the Federal Reserve Act, and would thus not be affected by a mandate change. The authority to purchase Treasury securities in the secondary market is also found in Section 14 of the act.

Failure to Respond to Rising Headline Inflation

As measured by the consumer price index, overall (referred to as "headline") inflation has been lower on average since 1992 than it had been since the mid-1960s. Although the Fed's record in this regard is very good, a case could nevertheless be made that the Fed should focus more on headline inflation and less on core inflation, particularly since headline inflation has outpaced core inflation in 10 of the past 12 years. One criticism that could be leveled at the Fed is that headline inflation rose above 3% before the last two recessions, and the Fed was too slow to respond at the expense of price stability and economic stability. The increase in overall inflation that preceded the last two recessions may suggest to some that there were important signals that the economy was overheating that the Fed may have neglected because of its focus on core inflation. Core CPI stayed below 3% before the two previous recessions.

The rationale for focusing on core inflation is that it is more representative of underlying inflationary pressures because it leaves out two highly volatile components, these being food and energy. A focus on increases in inflation caused by transitory movements in volatile components of the CPI could result in "false positives," leading to changes in interest rates when underlying inflationary pressures have not really changed. Headline inflation has generally outpaced core in recent years because commodity prices have tended to rise more rapidly than other prices, but it is not clear that this trend will continue in the future.

If it is believed that the Fed's focus on core inflation has led to poor policymaking, switching to a single mandate alone would arguably do little to solve the problem. As long as the Fed retained discretion to define price stability, it could continue to define price stability in terms of the performance of core inflation, or any other measure it favored. If an inflation target were adopted, any potential policy shift on this issue would depend on whether headline or core inflation were targeted.

"Bailing Out" Too Big to Fail Firms

In 2008, the Fed intervened financially to prevent two large financial firms, Bear Stearns and American International Group (AIG), from failing on the grounds that they were "too big to fail."[31] In other words, the Fed believed their failure would have undermined the stability of the financial system as a whole. Many critics have argued that these interventions increase risk in the

[31] For more information, see CRS Report R41073, *Government Interventions in Response to Financial Turmoil*, by Baird Webel and Marc Labonte. While the Fed has sometimes been characterized as "bailing out" Fannie Mae and Freddie Mac, it did not provide any funds directly to those firms. Rather, it purchased securities issued by those firms from other investors on the secondary market as part of its quantitative easing policy.

financial system in the long run by increasing "moral hazard," meaning that anticipated rescue from bad outcomes leads to greater risk taking.

The Fed also provided liquidity through a series of newly-created, broadly-based lending facilities to non-bank financial firms, such as primary dealers. Some critics argue that the Fed should not have provided assistance to firms that it did not regulate for safety and soundness, since the Fed cannot mitigate moral hazard at firms it does not regulate. Until 2010, the Fed regulated only bank holding companies, financial holding companies, domestic branches of foreign banks, and state-chartered member banks.

For both the assistance to AIG and Bear Stearns and the broadly-based facilities, the Fed provided assistance primarily through its emergency lending authority, found in Section 13(3) of the Federal Reserve Act. That authority was amended by The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), which attempted to prohibit future "bail outs" of failing firms, while allowing the Fed to set up broadly-based emergency liquidity facilities. Some critics felt that the Fed's emergency lending authority should be repealed or further restricted, but a change in the Fed's monetary policy mandate would not affect this authority.

Lax Supervision of the Financial System and Mortgage Markets

Some economists believe a root cause of the financial crisis was excessive risk-taking by financial firms. When risks were realized, these both contributed to the general panic and left those firms unable to survive the panic without government assistance. Some—but not all—of the firms that relied on Federal Reserve lending emergency facilities during the crisis were bank holding companies that were regulated by the Fed for safety and soundness. If the Fed had required these firms to take steps such as hold more capital or greater liquidity, the firms may have fared better in the crisis. The Fed is also accused of having failed to anticipate the problems that led to and exacerbated the crisis until it was too late.

The Fed also had regulatory responsibility for consumer products, such as mortgages. Critics argue that the housing bubble could have been avoided had the Fed used its consumer protection powers to prevent people from taking out unsuitable mortgages. A number of non-traditional mortgage products have proven in hindsight to have high default rates, and many of these products allowed borrowers to borrow more than they would have been eligible to with traditional products. It is argued that house prices could not have risen so quickly without the growth in non-traditional products.

Chairman Bernanke has admitted that the Fed and other regulators should have done more to protect consumers against unsuitable mortgages. He said

> The Federal Reserve and other agencies did make efforts to address poor mortgage underwriting practices…. However, these efforts came too late or were insufficient to stop the decline in underwriting standards and effectively constrain the housing bubble.[32]

The Fed's failure to prevent the crisis was not unique—domestic firms regulated by other regulators, foreign firms regulated by foreign regulators, and domestic firms that were not

[32] Chairman Ben S. Bernanke, "Monetary Policy and the Housing Bubble," Speech at the Annual Meeting of the American Economic Association, Atlanta, Georgia, January 3, 2010.

regulated for safety and soundness all experienced liquidity or solvency problems during the crisis. Few policymakers, investors, or academics accurately anticipated the problems that would arise from 2007 on.

The Fed's regulatory powers are not mentioned in its statutory mandate, and would not be affected by a change to a single monetary policy mandate. Its authority to regulate financial institutions for safety and soundness are found in Section 21 of the Federal Reserve Act and other parts of the U.S. Code. Its consumer protection responsibilities were not part of the original Federal Reserve Act, and were enumerated in a series of later acts. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), the Fed's general consumer protection responsibilities have been reassigned to a new Consumer Financial Protection Bureau, housed in the Fed.

Setting an Inflation Target: Implementation Issues

If Congress decided to legislate an inflation target, or the Fed decided to adopt one voluntarily, there are a number of institutional details to consider surrounding its scope and composition. Arguably, these issues would have important ramifications for economic and policy outcomes, as well as the scope of the Fed's discretion.[33]

Who Should Set the Inflation Target?

As discussed above, Congress could require an inflation target in statute, or leave it to the Fed to decide whether or not to adopt one. In addition, if Congress decided to require a target by statute, it could choose to set some of the parameters of that target in law or leave it to the Fed to set the parameters. Those parameters, discussed in the following sections, include the level of inflation to target, the price index to use for the target, whether to base the target on actual outcomes or forecasted outcomes, whether to target a point estimate or a band, and whether there should be penalties for missing the target. Any parameter that was set in law would be more difficult to change than if it were set by the Fed, for better or for worse.[34]

The consequence of setting the target and its attributes in law is that it would eliminate some of the Fed's discretion and accountability. As discussed above, for some policymakers, this would be a benefit as they believe that the discretion increases the risk of bad economic outcomes. For

[33] This discussion draws on C.A.E. Goodhart, and Jose Vinals, "Strategy and Tactics of Monetary Policy: Monetary Examples from Europe and the Antipodes" in *Goals, Guidelines, and Constraints Facing Policymakers*, op. cit, pp. 139-187; Guy Debelle and Stanley Fischer, "How Independent Should a Central Bank Be?," ibid, pp. 195-221; and Geoffrey Heenan, Marcel Peter, and Scott Roger, "Implementing Inflation Targeting," International Monetary Fund, working paper 06/278, December 2006**;** Robert Dittmar, William Gavin, Finn Kydland, "Price-Level Uncertainty and Inflation Targeting," *Federal Reserve Bank of St. Louis Review*, July 1999, pp. 23-33; Richard Dennis, "Bandwidth, Bandlength, and Inflation Targeting: Some Observations," *Reserve Bank of New Zealand Bulletin*, vol. 60, no. 1, 1997; Lars Svensson, *Inflation Forecast Targeting: Implementing and Monitoring Inflation Targets*, *European Economic Review,* vol. 41, 1997, pp.111-1146; Charles Carlstrom and Timothy Fuerst, "Monetary Policy Rules and Stability: Inflation Targeting versus Price-Level Targeting," *Federal Reserve Bank of Cleveland Economic Commentary*, February 2002; Pierre Siklos, "Inflation-Targeting Design," *Federal Reserve Bank of St. Louis Review*, March/April 1999, p. 47.

[34] The fact that the target can be changed in the future by either the Fed or Congress weakens some of the arguments made in its favor, such as enhanced accountability, transparency, and credibility.

others, it would be a drawback, because some flexibility is desirable to deal with unexpected economic developments and contingencies.

What Level Should be Targeted?

The first question regarding an inflation target is what rate of inflation is consistent with price stability? Taken literally, price stability might be understood to be an inflation rate of 0%, but this would be quite a departure from post-World War II history, when inflation has never remained below 1% for more than a few months at a time. A 0% inflation rate would minimize the "menu costs" associated with inflation which refers to the costs firms have to incur to respond to nominal price changes, such as a restaurant that must reprint menus. But since inflation will sometimes miss its target because of unexpected shocks, a zero percent target makes it more likely that the economy would sometimes experience deflation. Furthermore, getting to zero inflation, when households and investors have long-standing expectations that inflation will be positive, could require a short-term slowdown in the economy.

An alternative definition offered by Alan Greenspan is that "price stability is best thought of as an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms."[35] By this definition, the FOMC's long-run range for inflation of 1.5% to 2% might be considered price stability. Since measures of inflation such as the CPI are believed to overstate the "true" inflation rate, a low but positive rate of measured inflation may be equivalent to true price stability.

An alternative view is that a little inflation, say 4%, can "grease the wheels" of the labor market.[36] This view is based on the claim that workers are less willing in the short run to accept a nominal wage cut than the equivalent real wage cut if it contains a nominal wage increase. For example, workers would be less willing to accept a 2% wage *cut* when inflation is zero than a 2% wage *increase* when inflation is 4%, even though the two options are equivalent in terms of purchasing power. In other words, workers suffer from "money illusion"—a proposition that many economists reject. If this is true, then the labor market would clear faster, meaning real wages would fall faster when unemployment was high, and the economy would return to full employment faster with a little inflation. A higher average rate of inflation would also reduce the likelihood of swings into price deflation during recessions and give conventional monetary policy more room to stimulate before it hits the "zero bound" on interest rates.[37] This would have to be balanced against the higher costs, such as menu costs, associated with moderately higher inflation.

Some economists have argued that the level of prices (price index) should be targeted instead of the inflation rate (change in prices). They argue that this would lead to less uncertainty about the future path of prices, which would aid businesses with their planning, for example. On the other hand, targeting the price level could arguably be destabilizing since policy would have to compensate after unexpected "price shocks." For example, if prices exceeded the targeted level

[35] Chairman Alan Greenspan, "Transparency in Monetary Policy," Remarks by At the Federal Reserve Bank of St. Louis, Economic Policy Conference, St. Louis, Missouri (via videoconference), October 11, 2001.

[36] See, for example, George Akerlof, William Dickens, and George Perry, "Near-Rational Wage and Price Setting and the Long-Run Phillips Curve," *Brookings Papers on Economic Activity*, 2000, vol. 1, p. 1.

[37] Olivier Blanchard, Giovanni Dell'Ariccia, and Paolo Mauro, "Rethinking Macroeconomic Policy," International Monetary Fund, *Staff Position Note 10/03*, February 2010.

by 2% in the first year, prices would have to fall by 2% relative to the baseline in future years to return to the targeted path of prices. It is not clear that the short-term cost of creating higher inflation or deflation to return to the planned price level path is worth the benefits. By contrast, if inflation were targeted and exceeded the target, "bygones would be bygones" in future years. In practice, countries that have adopted inflation targets typically target inflation, not the price level.

A Point Estimate or A Range?

Another choice in the design of an inflation target is whether the target should be a point estimate, such as 2%, or a range, such as between 1%-3%. If a range were chosen, policymakers would also need to decide whether the midpoint of the range was most desirable, or if hitting any part of the range is equally acceptable.

Because monetary policy only indirectly influences inflation in the short run, and inflation is influenced by unexpected shocks, actual inflation is unlikely to often hit a point estimate exactly. This distinction is less important if it is implicitly understood that small deviations from the point estimate are acceptable. A range would make the tolerance of small deviations explicit, and make misses due to unexpected events less frequent. On the other hand, if unexpected shocks are large, then to make the range wide enough to never miss the target due to unexpected shocks could render the target meaningless.

If actual inflation were targeted, a range would be more transparent, since deviations are unavoidable and the amount of tolerable deviation would be explicit. If future inflation were targeted, a point estimate might be more appropriate since the goal of policy is to achieve some specific future goal, even though forecast error means the goal will rarely ever be hit precisely.

What Measure of Inflation Should be Targeted?

Separate from the question of what numerical value should be targeted is the question of what data source should be used for the target. This question, which is important for accountability reasons, raises a number of issues. First, there are several official measures of inflation. The Bureau of Labor Statistics issues multiple measures of inflation, and the Bureau of Economic Analysis (BEA) issues several more, but a target would be based on just one. Should the inflation target be based on the change in the prices of all goods in the economy, the change in the price of consumer goods, or the change in wages? The best known measure of inflation is arguably the headline CPI, but a drawback of the CPI is that it is thought to overstate inflation because of some methodological problems. Familiarity may be a benefit at first, but wane in importance once the targeted measure becomes well known. The GDP deflator issued by BEA is the broadest measure of inflation. On the other hand, the measures issued by BEA are only released quarterly and are subject to data revisions—two characteristics that some consider less desirable for an inflation target.

Assuming the selected measure of inflation is based on the price of goods, a further issue is whether volatile elements of the price index should be omitted from the target. In other words, should core or headline inflation be targeted? If core is targeted, how many items should be omitted? Traditionally, core inflation is measured by omitting food and energy prices, but

economists have also devised other measures of core inflation that they believe to have more desirable qualities.[38]

The benefit of using core inflation as a target is that removing volatile components of the inflation rate would make it less likely that the Fed would miss its target at any given time. It would also make it less likely that policy would be altered in response to transitory price changes. The drawback, as discussed above, is that targeting core inflation can lead to suboptimal performance if headline outpaces core for extended periods of time. An alternative approach to addressing price volatility would be to target overall inflation, but allow exceptions for unusual circumstances, such as an energy price spike. But too many exceptions could result in a level of discretion, accountability, and transparency that, in practice, was indistinguishable from current policy.

A final issue is whether recent (actual) inflation or future (forecasted) inflation should be targeted. Because monetary policy affects inflation only indirectly in the short run, and unexpected shocks often throw inflation off its expected path, the drawback to targeting actual inflation is that actual inflation will inevitably miss its target frequently. The other drawback to targeting actual inflation is that monetary policy affects inflation with lags. Inflation may be above the target in the period that has just occurred but be projected to fall below the target in the near future. If the Fed were responding to actual inflation, it may feel compelled to raise rates in this example, even though projections call for lower rates for the period that current monetary policy changes would influence. This hypothetical case is likely to be important in reality since inflation tends to peak right before the onset of a recession.

The drawback to targeting future inflation is that it would reduce transparency and accountability, particularly if the Fed were responsible for forecasting the inflation it was also targeting. There could be little consequence for actual inflation missing its target chronically, as long as the Fed produced forecasts that showed that it would meet the target in the future. It would be more difficult to apply any penalties (discussed below) to a regime based on targeting future inflation since the Fed would control the performance metric. Accountability might revolve less around why actual outcomes differed from desired outcomes and more around whether the Fed's forecasting was accurate, which could be difficult for Congress to evaluate.

Should There Be Penalties for Missing the Target?

If one goal of an inflation target is to increase the Fed's accountability to Congress, then a natural question is whether accountability should be buttressed by tangible consequences for bad results. Otherwise, admonitions for missing the target might be ignored. The difficulty with creating penalties is that the Fed's high degree of independence means that many potential penalties could either be toothless or draconian. For example, if a federal agency performed poorly, Congress could reduce or add restrictions to its budget in the following fiscal year. That option is not currently available for the Fed because it is self-financed and has budgetary independence.

One proposed penalty is that a missed target would trigger an automatic report to Congress or a Congressional hearing that would require the Fed to explain why the target was missed and how the situation would be remedied. Another proposed penalty is that the Chairman or Board could

[38] For more information, see CRS Report RS22705, *Inflation: Core vs. Headline*, by Marc Labonte.

be removed if the target were persistently missed or missed by a wide margin. This would be a significant change from current policy, under which governors (including the Chairman) can be removed only for cause, which is a higher standard than "at will" dismissal.

One argument against explicit penalties is that the Fed could be unfairly punished for events beyond its control, such as an oil price spike. The likelihood of this occurring would depend on the flexibility built into the target and the penalty.

Conclusion

Most arguments in favor of an inflation target fall into two categories: improved accountability of monetary policymakers and increased transparency of monetary policy to financial markets. Both are thought to result in better outcomes for the economy. A single mandate or inflation target may constrain the Fed's ability to pursue policies that result in high inflation, but in practice Fed policies over the past two decades have not resulted in high inflation. Nevertheless, past performance does not guarantee similar results in the future. Introducing an inflation target might be a way to "lock in" good policies.

In isolation, a change to a single mandate of price stability is unlikely to lead to a modification in monetary policy decisions since it would leave intact the Fed's independence and discretion to set policy as it sees fit. The dual mandate is only one of many institutional factors that contribute to the Fed's discretion and independence. Neither statute nor tradition formally lay out the consequences of missing the mandated goals; this makes accountability more difficult, but a switch to a single mandate in isolation would not alter that arrangement. An inflation target could potentially have more of an impact on the Fed's discretion, but the extent that its discretion would be constrained would depend on the characteristics of the inflation target, such as what consequences there would be if the target were missed, and whether the inflation target was selected and designed by the Fed or by Congress.

As practiced abroad, countries with a single mandate or inflation target have not ignored changes in unemployment, in part because they may help predict future changes in inflation. While this demonstrates that policymaking under one or both can be more flexible in practice than opponents paint it, it also begs the question of whether dropping maximum employment from the mandate is necessary or desired.

Some of the desire for legislative change comes from discontent with the Fed's recent performance. Therefore this report has analyzed two questions—what are the shortcomings in the Fed's recent performance, and would those shortcomings be affected by a mandate change?

Many of the criticisms of the Fed's performance—its "bailouts" of "too big to fail" firms, lax supervision of the financial system in the run up to the crisis, its passivity during the housing boom's run up of unsuitable mortgage debt—are unrelated to its monetary policy mandate, and involve authority derived from other parts of the Federal Reserve Act. Monetary policy's failure to prevent, and possibly exacerbate, the housing bubble, could argue in support of a mandate change. But because the housing bubble did not lead to high inflation, a single mandate would not likely modify the Fed's behavior in the face of future asset bubbles. A mandate change to require the Fed to explicitly address bubbles or financial stability might be a more effective means to this end. Criticism that the Fed should have done more to prevent the depth and length of the

recession implicitly speaks to the "maximum employment" part of the dual mandate, and so a single mandate would be unlikely to result in more aggressive countercyclical policy.

By conventional standards, the Fed's record on price stability in the last two decades is very good—headline inflation has been below 4% since 1991 and core inflation has been below 3% since 1995—but not perfect. It is also not significantly different than major inflation targeting countries. A criticism could be made that the Fed's focus on core inflation has not proven to be the optimal measure for obtaining price stability. But this criticism does not make the case that the Fed has neglected price stability, or that the Fed would be more focused on price stability under a single mandate. Unless Congress is involved in defining price stability (through the type of inflation to be targeted, for example), discretion would still remain with the Fed on what measure to focus on. A similar argument applies to criticisms that the Fed's program of quantitative easing is inconsistent with a price stability mandate—the Fed believes that quantitative easing is necessary to maintain price stability (to avoid deflation), and as long as the Fed has discretion to set its policies, a single mandate would not prevent quantitative easing.

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