



FEDERAL RESERVE BANK *of* NEW YORK

The Federal Reserve in the 21st Century

The Fed's Dual Mandate

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The views expressed in this presentation are those of the presenter and not necessarily those of the Federal Reserve Bank of New York or The Federal Reserve System

Outline

- The basis of the Fed's mandate
- Definition of objectives
 - Maximum employment
 - Price stability
 - January 2012 FOMC statement of longer-run goals and policy strategy
- The objectives in practice
 - Natural rate of unemployment vs. cyclical unemployment
 - Headline vs. underlying inflation
 - “Triangle” model of the inflation process
- Performance vs. Objectives
 - Recent performance and projected performance
 - Addition of policy path projections to January 2012 SEP



Statutory Basis for Conduct of Monetary Policy

- Central bank's goal in democratic societies is to foster economic prosperity and social welfare
- For the U.S. (and almost any other country), the central bank has more specific objectives established by the government
 - Mandate was originally specified by the Federal Reserve Act of 1913
 - Clarified by an amendment to the Federal Reserve Act of 1977
 - “. . . to effectively promote the goals of maximum employment, stable prices, and moderate long-term interest rates.”



The Dual Mandate

- The aforementioned goals of maximum employment and stable prices are often called the “dual mandate”
- Clarifying the Fed’s independence:
 - The Fed is not “goal” independent – The goals of maximum employment and stable prices are determined by Congress
 - The Fed is “instrument” independent – The choice of how to achieve the goals of maximum employment and stable prices is determined by the Fed



Objectives: Maximum (sustainable) employment

- *Long-run* employment and output are determined by:
 - Population growth, technological progress, preferences for saving, risk and work effort
 - **Not** by monetary policy
- In the *short-run*, the economy goes through ‘business cycles’
 - Output and employment fluctuate above or below long-run levels
- Monetary policy can help ‘smooth’ these fluctuations, and thus stabilize the economy
 - Monetary policy seeks to mitigate deviations of employment (output) from its ‘full-employment’ (potential) level



Objectives: Price Stability

- Defining price stability
 - “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” (Alan Greenspan)
- Prices act as the key mechanism for allocating resources efficiently throughout the economy;
- The central bank has primary influence over the long-run behavior of the general price level
- Over the short-run, policy seeks to mitigate deviations of inflation from its long-run objective



Longer-run Goals and Policy Strategy Statement

- Released by FOMC on January 12, 2012
- Intends to reaffirm and make appropriate adjustments each January
- Updated interpretation of the dual mandate:
 - Reiterate commitment to objectives of maximum employment and price stability
 - Emphasis on improved communication and enhanced transparency
 - Explicit long-run goal of 2% PCE inflation
 - Discussion of the balanced approach to Committee's policy decisions



The Objectives in Practice

- How do policymakers gauge whether the economy is operating at maximum (sustainable) employment?
- How do policymakers monitor inflation developments and assess the outlook for achieving price stability?
- What sort of model underlies policymakers' thoughts about the inflation process?



Full Employment

- “Full-employment” is a bit of a misnomer
 - Does not mean an unemployment rate = 0
 - Many indicators needed for this assessment
- Natural rate of unemployment:
 - Frictional causes: Turnover unemployment
 - Economy is dynamic
 - Jobs are continually created and destroyed
 - Workers are continually entering and exiting the labor market
 - Structural cases: Mismatch unemployment
 - Low-skilled workers may not have opportunities for long-term employment (skills)
 - Re-allocation of labor from shrinking industries/depressed regions to expanding industries/booming regions (location)

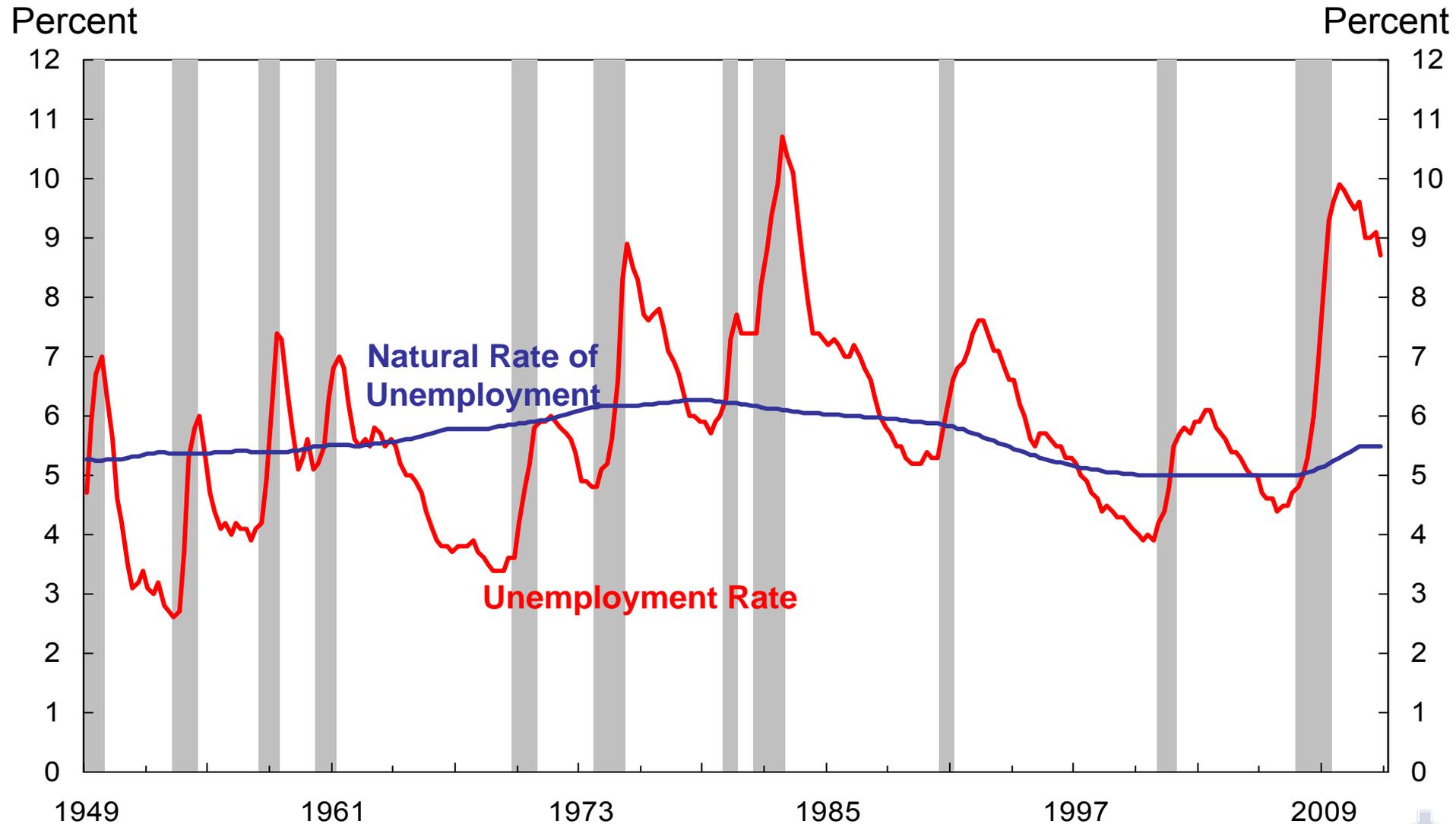


The Natural Rate of Unemployment

- The natural rate of unemployment is not directly observable and can vary over time
- Policies can be adopted to change the natural rate, but this lies largely in the domain of legislative action
- Particular concern with impact of recent recession on the natural rate of unemployment
 - Skills deterioration from increased unemployment duration
 - Impeded labor mobility due to weak housing market
- Cyclical unemployment is the difference between the actual unemployment rate and the natural rate of unemployment
 - Positive (negative) whenever the unemployment rate is above (below) the natural rate



Actual and Natural Rates of Unemployment



Total/Headline vs. Underlying Inflation

- General price changes in an economy reflect a mixture of persistent (sustained) and temporary (transitory) changes
- It is critical for policy makers to differentiate between these types of price movements for the conduct of monetary policy
- Measures of underlying inflation are designed to remove transitory price changes and serve as a means to an end:
 - Gauge of inflation over the medium-run to guide policy to achieve a total/headline inflation objective
 - Focus of a central bank on a price index excluding certain items does not imply a lack of interest or concern about these items



Measures of Underlying Inflation

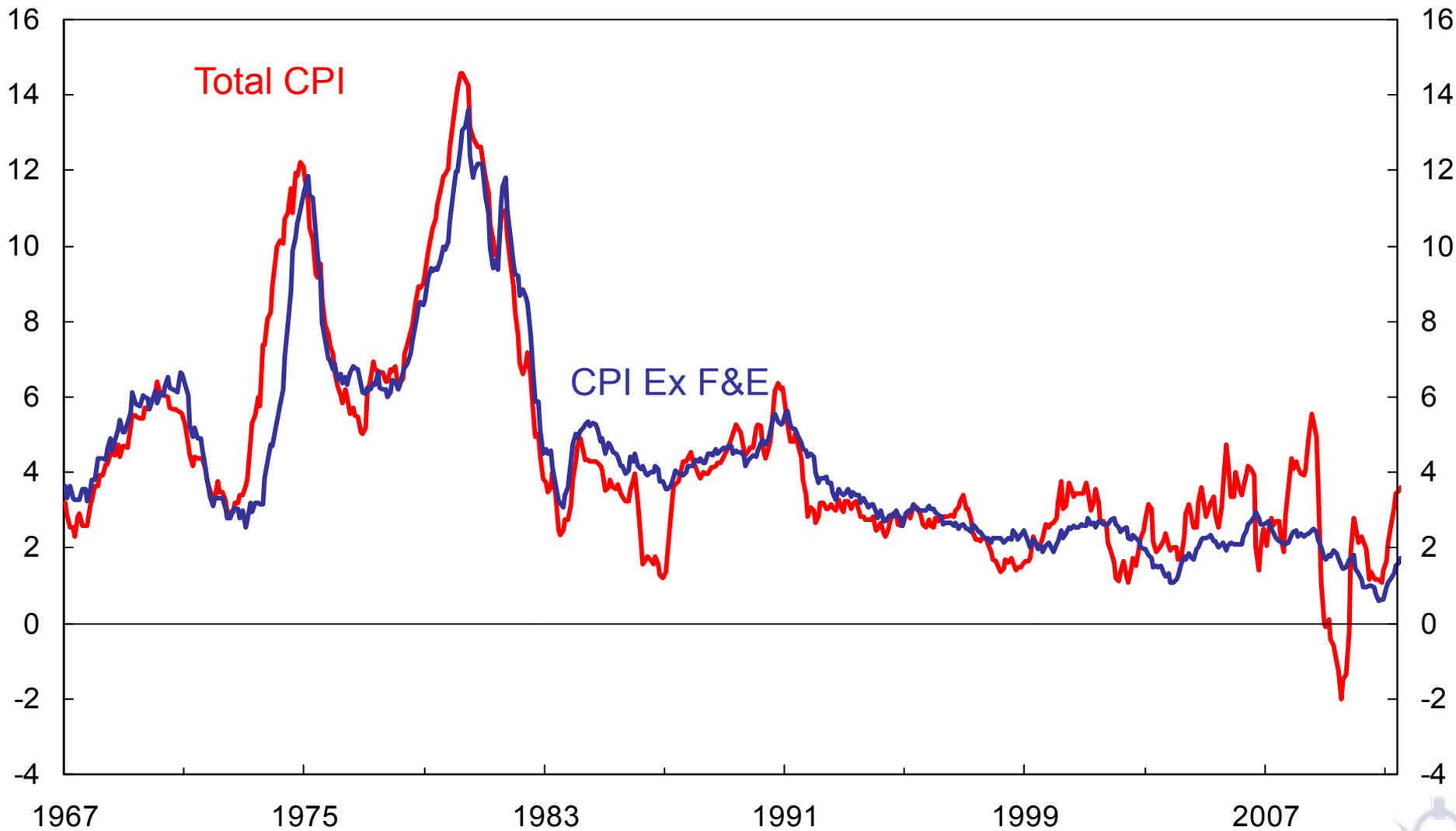
- The construction of a measure of underlying inflation rests critically on the source(s) of transitory price changes
 - Long-held view that food and energy prices are the most volatile components
 - Ex-food and energy measure of inflation
 - Alternative view that transitory price changes are not associated with specific components, but rather with the “tails” of the price change distribution:
 - Weighted median measure of inflation
 - Trimmed mean measure of inflation



CPI Inflation: Total and Ex Food and Energy

% Change - Year to Year

% Change - Year to Year



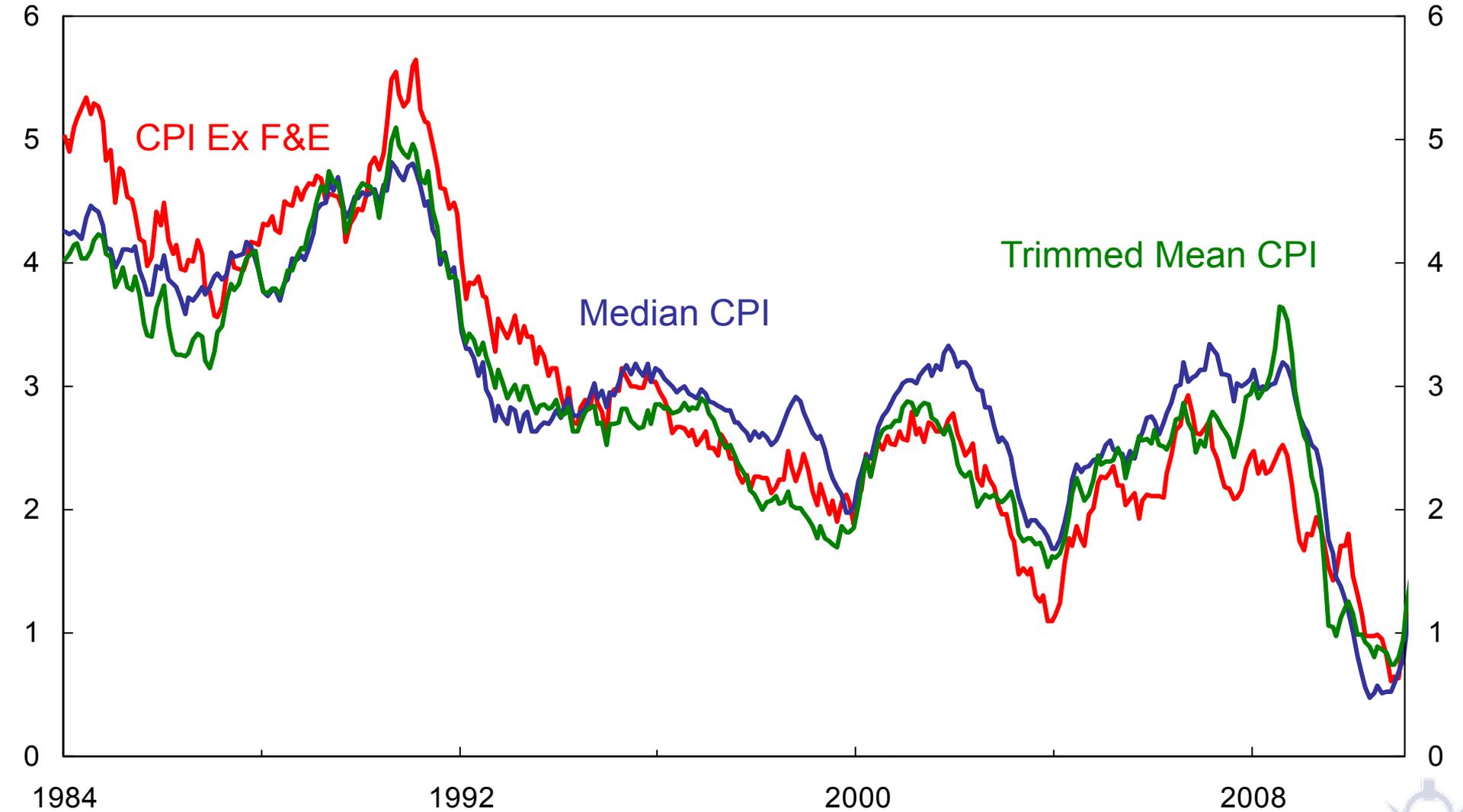
Source: Bureau of Economic Analysis



Alternative Measures of Underlying CPI Inflation

% Change - Year to Year

% Change - Year to Year



The Inflation Process

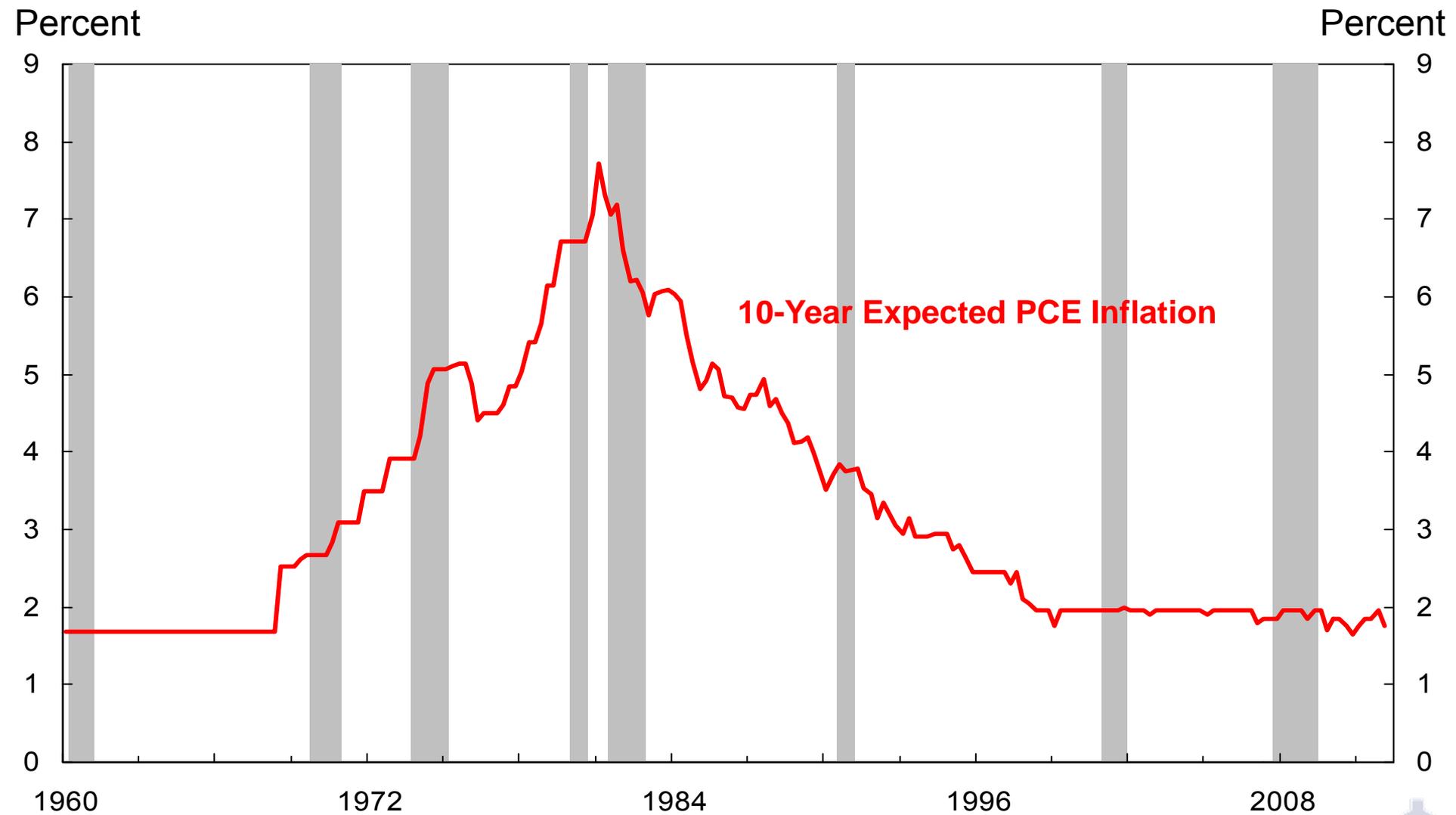
- What determines inflation?
 - Inertial component
 - Excess demand/slack in resource utilization
 - Supply shocks
- Inflation is influenced by several factors. When discussing movements in inflation (past, present, future), these factors need to be considered in conjunction rather than in isolation

Inertial Component

- Inflation tends to deviate only gradually from its own past values
 - Slow adjustment of inflation expectations
 - Importance of “well-anchored” inflation expectations around levels consistent with objectives of price stability
 - Existence of wage and price contracts in the economy



Long-term Inflation Expectations



Source: BLS, Survey of Professional Forecasters



Excess Demand/Slack in Resource Utilization

- At full employment, there is no inherent tendency for inflation to accelerate or decelerate:
- Activity gap measures used to gauge demand pressures (relative to “full-employment”) in the economy:
 - Unemployment relative to the natural rate/NAIRU
 - Output relative to “potential” or “natural” output (output gap)
 - Capacity utilization relative to the non-accelerating inflation rate of capacity utilization (NAIRCU)
- Activity gap measures are not directly observable, but instead must be derived using theory and statistical methods



Supply Shocks

- Inflation can also be influenced by external factors that result in sharp changes in business costs
- These “supply shocks” can be adverse or beneficial:
 - Import prices vs. energy prices/exchange rate
 - Oil prices are difficult to model (volatility, etc.)
 - Slippage from exchange rate to domestic inflation due to time-varying pass-through to import prices
 - How import prices can affect inflation:
 - Components of the domestic price index
 - Induce domestic firms to alter prices of competing goods
 - Change in relative import prices is important for gauging inflationary pressures



Summary of Economic Projections (SEP)

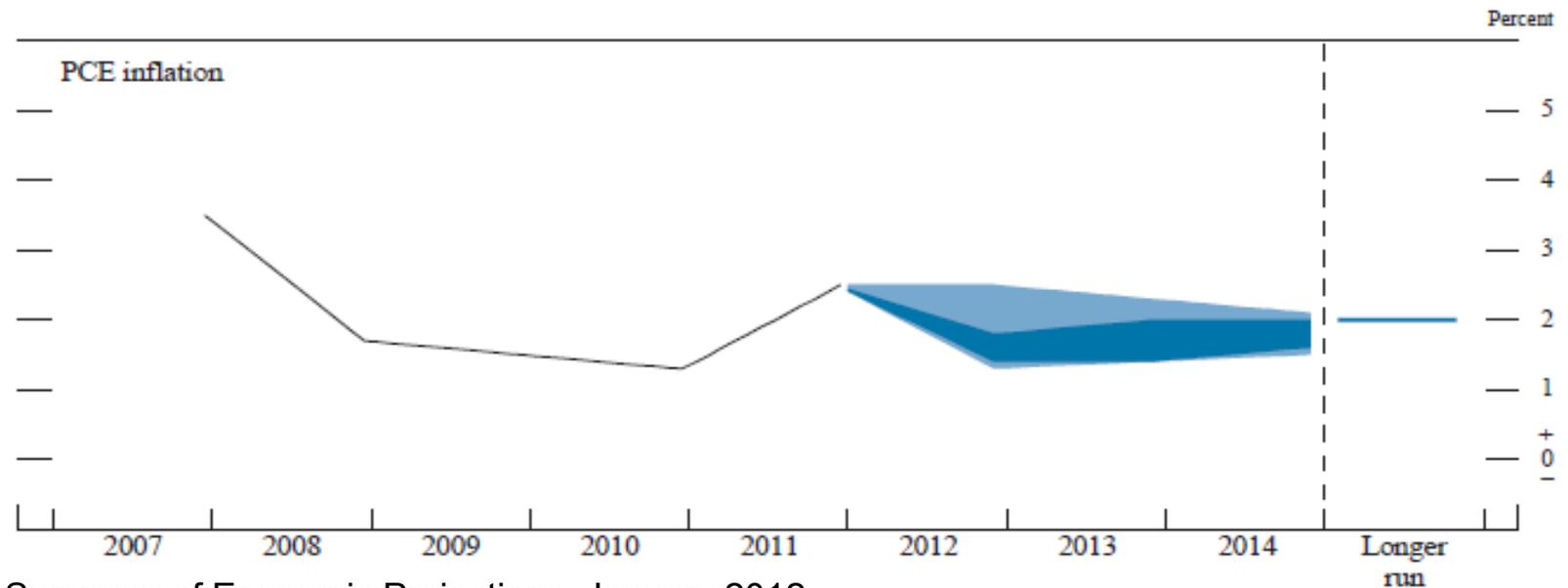
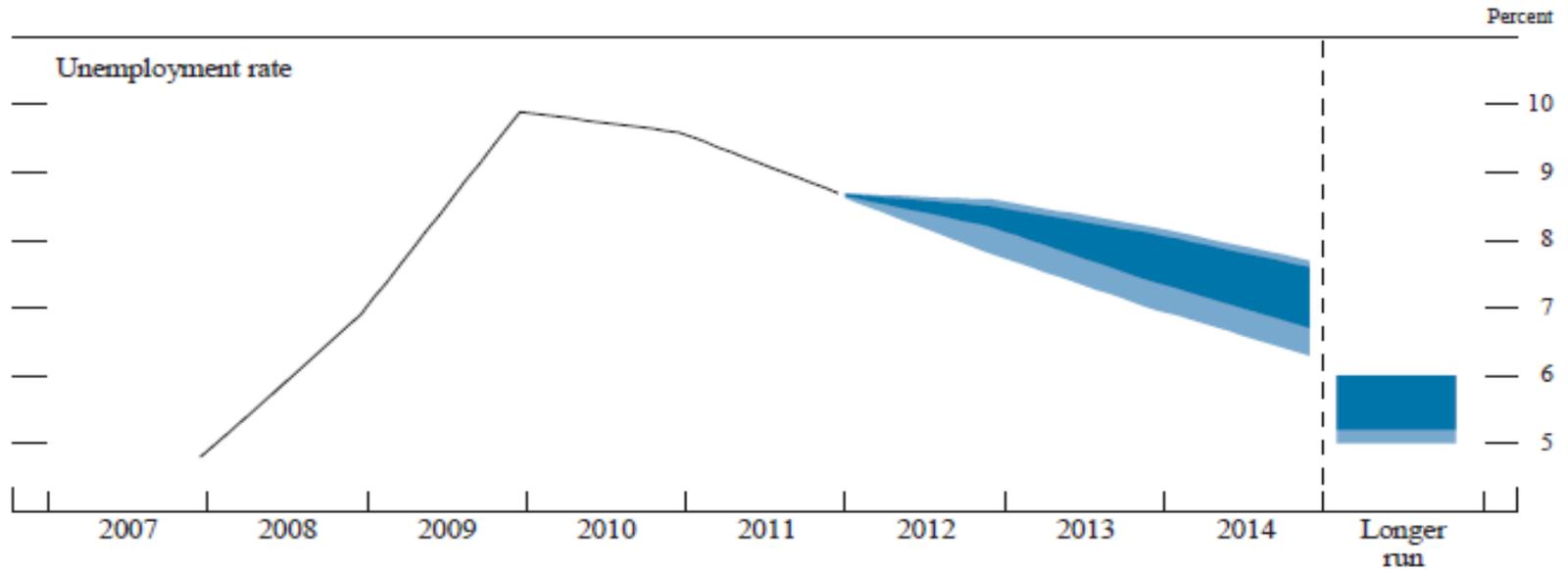
- “Enhanced Fed Communication”: initiated in October 2007
 - Published with the minutes four times a year
- FOMC participants’ forecasts for output growth, unemployment and inflation over the medium term (the next three years) and for the “long run”
 - Forecasts are made under an “appropriate policy” assumption – until recently, no communication about specific policy path underlying each participant’s forecast
 - Starting with January 2012 SEP, additional charts now depict policymakers’ projections of path of federal funds rate (FFR) target under appropriate policy

Summary of Economic Projections (SEP)

- SEP conveys a quantitative assessment of the FOMC's objectives
 - Long-run unemployment forecast can be interpreted as an estimate of the natural rate/NAIRU
 - FOMC view: unemployment rate of 5.2 – 6% consistent with maximum employment goal
 - Long-run inflation forecast now represents an explicit inflation objective
 - FOMC view: annual PCE inflation of 2% defines price stability goal



SEP (January Projections)



Source: Summary of Economic Projections, January 2012

Summary of Economic Projections (SEP)

- SEP policy path charts:
 - Policymakers' projections of appropriate path for federal funds rate (FFR) target
 - Appropriate timing of policy firming
 - Target federal funds rate at year-end