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The Fed Needs a New, Simpler Mandate

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By Clive Crook a A

Last Friday's disappointing U.S. jobs numbers came as less of a surprise to Ben Bernanke than to many others. The Federal Reserve chairman had warned that the earlier pace of improvement in the labor market might tail off. Unfortunately, being right about that won't make his job over the coming months any easier.

In uniquely difficult circumstances, Bernanke has tried to make monetary policy more effective by using new tools and communicating the Fed's thinking more fully. The first has worked well but the second hasn't. The problem is that the Fed's aims are opaque. That's why greater transparency has done nothing to clarify its actions.

The central bank's dual mandate asks it to strive for two things: full employment and price stability. At the outset, those goals are ambiguous. Is full employment a jobless rate of 4 percent, or 6 percent, or what? Difficult to say. Does price stability mean zero inflation? Some say it should, but the Fed takes it to mean inflation of 2 percent.

DUAL-MANDATE BLUES

The main thing, though, is the trade-off. Any effort to boost employment with easier monetary policy risks pushing up inflation. Curbing inflation once it has started accelerating risks driving the economy into a recession. Balancing the two isn't easy. The dual mandate is like somebody promising to work harder for promotion and to spend more time with his family. It leaves the question of priorities hanging. As long as that's unresolved, further discussion is beside the point.

Lots of information telling you nothing is about where the Fed now stands. Even if financial markets knew where the economy was heading, they couldn't be sure what the Fed will do.

According to the Fed's forecasts, the economy will grow at a slowish rate this year -- more slowly than you would expect given the depth of the recession. That was why Bernanke was gloomier than some about employment. In March, the economy created just 120,000 new jobs, far too few to get unemployment down. The jobless rate did fall another notch, to 8.2 percent, but only because of people dropping out of the workforce altogether.

What about inflation? Right now, it's drifting lower, and that's expected to continue. The Cleveland Fed estimates 10-year expected inflation each month from the yield on the Treasury's inflation-protected bonds. In March, 10-year expected inflation was less than 1.4 percent.

Slow growth, high unemployment and less-than-target inflation: On the face of it, an open-and-shut case for another round of quantitative easing. The trouble is, nudging up expectations of inflation is implicitly part of what QE is intended to do. That shouldn't be a problem when expected inflation is running so low, but it is -- an aspect of the policy that dares not speak its name. The Fed is reluctant to look as though it's taking chances with its goal of price stability.

On this key point, commentators have noticed the contrast between Professor Bernanke and Fed Chairman Bernanke. Advising a depression-struck Japan 10 and more years ago, the professor called for monetary easing by any means necessary. Inflation is too low, he said, so don't hold back. Actually, make higher inflation rates your goal. Caution and orthodoxy are destroying your economy. Chairman Bernanke, critics say, is failing to follow his own advice.

VANISHING JOBS

This is unfair, but the critics have a point. They are too harsh because the U.S. in 2012 is not Japan in 2001. The economy is growing and prices aren't falling. The Fed's decision is a closer call.

Also, don't entirely dismiss concerns about how soon the economy will run into supply constraints. The main body of research suggests that unemployment can fall a lot further before higher wages start to press on inflation. But reports of skills shortages and a newer strand of academic work raise doubts. A paper by Nir Jaimovich and Henry Siu suggests that the recession may have accelerated "job polarization" -- meaning permanent losses in the middle of the labor force, among workers doing jobs that are skilled yet susceptible to automation. If these positions aren't coming back, new stimulus might raise the inflation rate sooner than we think.

This gives the Fed's inflation hawks one more reason to urge caution. And Bernanke has to take their views into account. Monetary policy isn't his alone to make. He won't want to find himself in the minority on his own Federal Open Market Committee, the Fed's policy-making panel. An unintended consequence of FOMC transparency is that it strengthens dissenters. Bernanke won't argue as strenuously as he might wish for new QE if he thinks he can't carry a consensus.

A simpler mandate would cut through some of these problems. I'm keen on an old idea that has recently attracted new support. Tell the Fed to target not inflation and full employment but growth in the money value of gross domestic product. A target for growth in nominal GDP is no panacea. It wouldn't make central banking easy, and you could implement it in different ways -- a further source of contention. But the basic approach has big advantages.

In effect, it merges the two halves of the existing mandate, allowing the Fed to be agnostic, as it should be, about the underlying components. Suppose the target was medium-term growth in nominal GDP of 5 percent a year. That might be inflation of 2 percent and growth in output of 3 percent, or stable prices with 5 percent growth, or zero growth with 5 percent inflation. Obviously those outcomes aren't equally desirable -- but the point is that the Fed can't steer the components, only the aggregate.

A NOMINAL SOLUTION

Monetary stimulus adds to demand. How that demand breaks down between inflation and output is beyond the Fed's control. The Fed shouldn't be held accountable for outcomes it cannot direct. And the presentational advantage really matters. At the moment, nominal GDP is less than 4 percent. The Fed would say: According to the mandate, it needs to be increased; in QE, we have the means to increase it. End of discussion.

The argument between inflation hawks and doves isn't settled, but it's suspended, which is fine. If the recession has permanently undermined the economy's capacity to grow, a 5 percent nominal GDP target might yield over time growth of, say, 2 percent a year with inflation of 3 percent, rather than vice versa, as we'd like. Once that becomes clear, we can talk about reducing the nominal GDP target to 4 percent. Meanwhile the 5 percent target keeps inflation within clear bounds without choking off the possibility of faster growth.

With a simpler goal -- one it could actually achieve -- the Fed would have less to argue about and less to explain. It would be more accountable. And transparency would provide clarity, which is stabilizing, rather than the current muddle, which isn't.

(Clive Crook is a Bloomberg View columnist. The opinions expressed are his own.)

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