Economic Brief

December 2011, EB11-12

The Federal Reserve's "Dual Mandate": The Evolution of an Idea

By Aaron Steelman

Since 1977, the Federal Reserve has operated under a mandate from Congress to "promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates"—what is now commonly referred to as the Fed's "dual mandate." The idea that the Fed should pursue multiple goals can be traced back to at least the 1940s, however, with shifting emphasis on which objective should be paramount. That such a mandate may, at times, create tensions for monetary policy has long been recognized as well.

At the conclusion of World War II, with millions of American soldiers returning home, a large share of the workforce concerned about finding jobs as the economy transitioned from the production of wartime goods, and the specter of the Great Depression fresh in the minds of nearly all, Congress passed the Employment Act of 1946. At the heart of the Act was its "Declaration of Policy":

> The Congress hereby declares that it is the continuing policy and responsibility of the federal government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment, for those able, willing, and seeking work, and to promote maximum employment, production, and purchasing power.[1]

The Act was the product of numerous revisions to what was originally introduced as the "Full Employment Bill of 1945." It had declared:

> All Americans able to work and seeking work have the right to useful, remunerative, regular, and full-time employment, and it is the policy of the United States to assure the existence at all times of sufficient employment opportunities to enable all Americans who have finished their schooling and who do not have full-time housekeeping responsibilities to freely exercise this right.[2]

Conspicuous in the final bill is the removal of the claim that citizens have a "right" to a job; so, too, is the acknowledgment of the importance of maintaining purchasing power—that is, the need to keep inflation in check. Political scientist Stephen Kemp Bailey attributed such changes, in large measure, to opposition among certain members of the House of Representatives who viewed the original bill as too radical and wished to produce a substitute that would "exclude the last remnants of … dangerous federal commitments and assurances (including the wording of the title), but would provide for an economic

planning mechanism of some sort in the Executive and legislative branches, and for a moderate program of public works."[3]

While most of the people who testified about the original bill were largely supportive of its goals, there were dissenting voices who thought it dangerously neglected the issue of price stability. Among them was Harvard University economist Gottfried Haberler, who stated:

> It will be essential to prevent partial, localized unemployment from spreading depression to other fields. This can be done by supporting aggregate expenditure if it is necessary; but it does not follow that unemployment can be eradicated by simply spending more until full employment is reached. Long before that point is reached, inflationary price rises would be produced. If it were possible to shift labor and other resources easily and quickly from excess areas to the points where scarcities exist, we would not need to worry. But experience teaches that such shifts cannot always be made sufficiently fast.[4]

Similarly, economist Walter A. Morton of the University of Wisconsin argued, "One of the defects of this bill, in my opinion, is its failure to prescribe a price policy." He elaborated:

> Now I recognize that it is not possible to legislate regarding any particular price, nor regarding any price level, but I do think it is both necessary and desirable to state that it is the policy of the United States to prevent inflation of prices; to maintain a stable level of wholesale prices, and a stable cost of living; provided, however, that such stability shall not preclude a secular downward movement of prices and the cost of living as industrial efficiency increases.[5]

During the 25 years immediately following the passage of the 1946 Act, the American economy generally performed quite well. While there was significant inflation in the last half of the 1940s, annual inflation rates typically ranged from 1 percent to 5 percent during the rest of this period. The labor market also performed quite well, with annual unemployment rates trending around 5 percent. But both inflation and unemployment began to rise in the early 1970s, bringing about a period of "stagflation." Not surprisingly, worsening economic conditions prompted both the president and Congress to act.

President Ford delivered his famous "Whip Inflation Now" (WIN) speech on October 8, 1974, during which he enumerated 10 proposals. His fourth proposal captured the widespread desire to address both inflation and unemployment simultaneously, albeit in a way that was unlikely to prove efficacious and thus demonstrating the difficulty of the problem:

> We need more capital. We cannot "eat up our seed corn." Our free enterprise system depends on orderly capital markets through which the savings of our people become productively used. Today, our capital markets are in total disarray. We must restore their vitality. Prudent monetary restraint is essential.
>
> You and the American people should know, however, that I have personally been assured by the Chairman of the independent Federal Reserve Board that the supply of money and credit will expand sufficiently to meet the needs of our economy and that in no event will a credit crunch occur.[6]

Meanwhile, in early 1975, Congress adopted Resolution 133 instructing the Federal Reserve to, among other things:

> 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.[7]

In 1977, Congress amended the Federal Reserve Act to incorporate the provisions of Resolution 133, but only after debating more ambitious proposals. In a 1976 hearing on the Employment Act of 1946, Senator Hubert Humphrey commented, "It is my judgment that that law has, from time to time, been conveniently ignored."[8] He wanted to adopt legislation that would enumerate more explicit employment goals, and if those goals were not met to have the government provide jobs to achieve the target.

Humphrey also wished to give the executive branch a greater role in the execution of monetary policy. The president would submit his recommendations for monetary policy, and the Federal Reserve Board of Governors would have to respond within 15 days to explain any proposed deviation. Neither proposal passed, but Humphrey and his colleague in the House, Augustus Hawkins, continued to push for similar legislation. Humphrey died in January 1978, but later that year, the "Full Employment and Balanced Growth Act," better known as the Humphrey-Hawkins Act, was signed into law by President Carter.[9]

The Humphrey-Hawkins Act contained numerous objectives, some of them relatively vague and perhaps contradictory, but with respect to unemployment and inflation, the objectives were clear. Within five years, unemployment should not exceed 4 percent for people 16 years or older, and inflation should be reduced to 3 percent or less, provided that its reduction would not interfere with the employment goal. And by 1988, the inflation rate should be zero, again provided that pursuing this goal would not interfere with the employment goal.[10] Of course, the legislation was not binding in any real sense. Congress could not simply mandate such unemployment and inflation rates; it could set them only as targets. Still, Congress demonstrated, and made more explicit, the idea that the Federal Reserve should work to achieve both employment and inflation goals.

Not long after the Federal Reserve Act was amended and the Humphrey-Hawkins Act was passed, the Federal Reserve came under scrutiny for ignoring one side of its "dual mandate."[11] Under the leadership of Chairman Paul Volcker, the Federal Reserve pursued an aggressive set of policies designed to reduce inflation. While those policies did bring inflation down from more than 13 percent in 1980 to roughly 3 percent in 1983, unemployment rose sharply during that period, from roughly 7 percent to more than 10 percent, the highest in the postwar period up to that point. Volcker defended the Fed's actions in 1981 testimony to the Senate Committee on Banking, Housing, and Urban Affairs:

> I am wholly convinced—and I think I can speak for the whole Board and whole Open Market Committee—that recognizing that that objective for unemployment [4 percent] cannot be reached in the short run—the kinds of policies we are following offer the best prospect of returning the economy in time to a course where we can combine as full employment as we can get with price stability.
>
> I bring in price stability because we will not be successful, in my opinion, in pursuing a full employment policy unless we take care of the inflation side of the equation while we are doing it. I think that philosophy is actually embodied in the Humphrey-Hawkins Act itself. I don't think that we have the choice in current circumstances—the old tradeoff analysis—of buying full employment with a little more inflation.
>
> We found out that doesn't work, and we are in an economic situation in which we can't achieve either of those objectives immediately. We have to work toward both of them; we have to deal with inflation. And the Federal Reserve has particular responsibilities in that connection.[12]

Volcker's explanation did not satisfy many members of Congress, who charged the Federal Reserve with ignoring the employment aspect of its dual mandate. In a 1982 hearing before the House Committee on Banking, Finance, and Urban Affairs, Chairman Fernand St. Germain asked Volcker: "And in order to bring inflation down even further in 1982, how many American citizens are going to have to look forward to sacrificing in the form of unemployment?" He went on to argue that "the question, I think, in the minds of most American people today—it seems to be more important to the American people now than the rate of inflation—and that is unemployment."[13]

Similarly, Volcker faced sharp questioning from Rep. Mary Rose Oakar. "I mean I have to lay it on the line, I do not think you are concerned," she stated. "Here you are mandated by the Humphrey-Hawkins Act, which has as its major goal full employment for the country, and you come to this committee and you say you mentally discount unemployment."[14] (This was not quite an accurate representation of

Volcker's views. He had originally made a statement attempting to address the effects of the increase in unemployment on growing budget deficits, stating, "When I look at that deficit, I mentally discount the part that is due to the rise in the unemployment rate and the recession." His argument was that fiscal imbalances were likely to persist even if the economy recovered; he did not dismiss the importance of unemployment generally.)

Eventually, the Fed's policies of steadfastly pursuing price stability did contribute to a favorable macroeconomic environment, with the economy growing and unemployment dropping sharply during the mid- to late-1980s. (Inflation remained relatively tame during this period as well, ranging from roughly 2 percent to 5 percent annually, with most years seeing an increase in prices of 3 percent to 4 percent.) As a result of this apparent success, talk of the Fed's responsibility to pursue its dual mandate largely dropped from public discourse until the mid-1990s, when some members of the Federal Open Market Committee (FOMC) called for the Fed to adopt an explicit inflation target. While this policy had been adopted—in writing if not always in practice—by a number of countries, there was skepticism among other members of the FOMC. Their discomfort with the proposal was due, at least in part, to the belief that an explicit inflation target would not give the Fed sufficient discretion to pursue its mandate of achieving maximum employment, or maximum *sustainable* employment, as some people had begun to refer to the Fed's charge.

In particular, Vice Chairman Alan Blinder was opposed to such a change in Fed policy. At the January 31–February 1, 1995 meeting of the FOMC, he stated:

> As usual, let me defend the status quo. We have a dual objective in the Federal Reserve Act now. I think it works very well. I think the case that it is broken and needs fixing is extremely thin. . . . There is no existing evidence—and I can't say this too strongly—that having such targets leads to a superior trade-off. None at all. It is not one of those cases in which the evidence is equivocal. There is nothing that can be cited.[15]

While the idea that the Federal Reserve should pursue a "dual objective"—"dual mandate," as Blinder and many in the media soon began to call it—had been around for decades, the term itself did not emerge in common parlance until 1995. Since then, its usage has become widespread among policymakers and journalists. However, it was not until recently that the FOMC addressed employment explicitly in its policy statement. Instead, the FOMC preferred to mention sustainable economic growth and price stability. As Daniel L. Thornton of the Federal Reserve Bank of St. Louis has written:

> . . . until the September 21, 2010, meeting, there was no reference to the objective of maximum employment elsewhere in the policy directive or in the FOMC's statement. The September statement read, "Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote *maximum employment* and price stability" [italics added]. Reference to the objective of maximum employment was more prominent in both the November 2–3, 2010, policy directive and the FOMC's policy statement. Both included the statement, "Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Currently, the unemployment rate is elevated, and measures of underlying inflation are somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate.[16]

The FOMC has continued to mention its statutory requirement to seek maximum employment and price stability in subsequent statements. Why the recent acknowledgment of the dual mandate in public statements? Any answer to that question is speculative. As Thornton notes:

> It is not clear whether the direct reference to the objective of maximum sustainable employment reflects a change in the FOMC's belief regarding the extent to which its actions can affect employment or merely reflects a desire to explicitly recognize its mandate, perhaps motivated by the fact that the unemployment rate remains unacceptably high. In this regard, it is interesting to note that the unemployment rate was

8 percent or higher from November 1981 to January 1984 without a significant change in the wording of the FOMC's policy directive.

During its nearly 100-year history, the Federal Reserve has evolved considerably regarding both the scope of its duties and the actions it has taken to meet them. Prominent during most of its existence, though, has been the idea that it is responsible for both securing the value of the nation's currency as well as promoting employment. At times, public sentiment has seemed to favor one objective over the other, and currently most Americans, understandably, seem more concerned about the high rate of unemployment than inflation. To be sure, unemployment is a significant problem—one that affects millions of struggling American families—and the Fed must continue to be mindful of unemployment when making policy. Toward that end, many economists have argued that, in the long run, the most effective means by which the Fed can help people get back to work is to ensure that prices remain stable, so that businesses can make rational, foresighted decisions that would produce economic growth and a healthier labor market. This remains a topic of much discussion and debate among economists and policymakers. In that regard, the "dual mandate" is far from a historical matter, though why the Fed was given that charge and how it has responded to it in the past perhaps will shed light on proposals to address current macroeconomic problems. ▪

Aaron Steelman is director of publications in the Research Department at the Federal Reserve Bank of Richmond.

Endnotes

[1] Quoted in Stephen Kemp Bailey, *Congress Makes a Law: The Story Behind the Employment Act of 1946*, New York: Columbia University Press, 1950, p. 228.

[2] Quoted in Bailey, p. 243.

[3] Bailey, p. 165.

[4] Letter from Gottfried Haberler to Senator Robert F. Wagner, chairman of the Banking and Currency Committee, May 18, 1945.

[5] Letter from Walter A. Morton to Senator Robert F. Wagner, chairman of the Banking and Currency Committee, May 7, 1945.

[6] "Whip Inflation Now," Address by President Gerald R. Ford to the U.S. Congress, October 8, 1974.

[7] Quoted in Allan H. Meltzer, *A History of the Federal Reserve: Volume 2, Book 2, 1970–1986*, Chicago: University of Chicago Press, 2009, p. 986.

[8] Quoted in Meltzer, p. 987.

[9] In a 1986 paper, G.J. Santoni, then of the Federal Reserve Bank of St. Louis, argued that the more ambitious measures of the Humphrey-Hawkins Act were stripped away, as they were from the 1945 bill that became the Employment Act of 1946. He wrote: "The Humphrey-Hawkins Bill of 1976 attempted to revive the main provisions of the 1945 bill. Congress, however, had become no more sympathetic in the intervening 30 years. As in 1946, they extracted the legislation's teeth before approving it and created an 'unworkable monster' by loading the bill with an agglomeration of conflicting policy statements." See G.J. Santoni, "The Employment Act of 1946: Some History Notes," Federal Reserve Bank of St. Louis *Review*, November 1986, p. 15.

[10] "Full Employment and Balanced Growth Act of 1978," Public Law 95-523, October 27, 1978, pp. 8–9.

[11] Although the 1977 amendment to the Federal Reserve Act instructed the Fed to pursue three goals—maximum employment, stable prices, and moderate long-term interest rates—the third goal is rarely discussed. In a 2007 speech, former Federal Reserve Governor Frederic S. Mishkin succinctly described the reason for its omission: "Because long-term interest rates can remain low only in a stable macroeconomic environment, these goals are often referred to as the *dual mandate*; that is, the Federal Reserve seeks to promote the coequal objectives of maximum employment and price stability." See Frederic S. Mishkin, "Monetary Policy and the Dual Mandate," address at Bridgewater College, Bridgewater, Va., April 10, 2007.

[12] Federal Reserve Chairman Paul Volcker, "Federal Reserve's First Monetary Policy Report for 1981," Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, February 25 and March 4, 1981, U.S. Government Printing Office, p. 28.

[13] Rep. Fernand St. Germain, "Conduct of Monetary Policy," Hearings before the U.S. House of Representatives Committee on Banking, Finance, and Urban Affairs, February 10 and March 30, 1982, U.S. Government Printing Office, p. 53.

[14] Rep. Mary Rose Oakar, "Conduct of Monetary Policy," Hearings before the U.S. House of Representatives Committee on Banking, Finance, and Urban Affairs, February 10 and March 30, 1982, U.S. Government Printing Office, p. 84.

[15] Transcript of the meeting of the Federal Open Market Committee, January 31–February 1, 1995, p. 52.

[16] Daniel L. Thornton, "What Does the Change in the FOMC's Statement of Objectives Mean?" Federal Reserve Bank of St. Louis *Economic Synopses*, 2011, No. 1, p. 2.

This article may be photocopied or reprinted in its entirety. Please credit the authors, source, and the Federal Reserve Bank of Richmond and include the italicized statement below.

The views expressed in this article are those of the authors and not necessarily those of the Federal Reserve Bank of Richmond or the Federal Reserve System.