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BACKGROUNDER

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Give the Fed a Single Mandate: Monetary Neutrality

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Abstract

Successful monetary policy is important to America's workers, retirees, and savers. Too little money in the economy can cause an economic downturn, while too much can create artificial—and therefore unsustainable—economic gains. People are best served by neutral monetary policy, whereby the central bank supplies just the amount of money the economy needs to keep moving, no more and no less. Given the existing centrally managed fiat money framework in the U.S., Congress can greatly improve monetary policy by replacing the Federal Reserve's so-called dual mandate. Congress should give the Fed the single goal of achieving monetary neutrality by stabilizing overall spending in the economy. Targeting total spending would give the Fed the best chance of achieving monetary neutrality because that framework requires the central bank to respond to changes in the demand for money. This new framework would be superior to inflation targeting because it would allow the price level to rise and fall as productivity changes.

Not having enough money in the economy can lead to an economic downturn. This is one reason why monetary policy is important to America's workers, retirees, and savers. However, there is such a thing as too much money in the system. As with virtually all economic policies, people are better served when the federal government remains neutral than when it actively tries to boost or slow down economic activity based on the preferences of policymakers and politics. Successful monetary policy, therefore, requires the Federal Reserve to remain neutral by supplying the amount of money the economy needs in order to keep moving—no more and no less.

Key Points

- Congress can greatly improve monetary policy by replacing the Federal Reserve's current legislative mandate to promote stable prices and maximum employment with a mandate that has the single goal of achieving monetary neutrality by stabilizing overall spending in the economy.
- Targeting total spending is the best way for the Fed to maintain monetary neutrality—supplying the amount of money the economy needs to keep moving, no more and no less.
- A central bank that targets total spending has the best chance of achieving monetary neutrality, because this targeting effectively requires the central bank to respond to changes in the demand for money.
- This framework would be superior to inflation targeting because it would allow prices to better reflect goods' actual scarcities, and because it would avoid major information problems faced by inflation-targeting central banks.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3367**

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Congress can greatly improve monetary policy by replacing the Fed's current legislative mandate to promote stable prices and maximum employment.[1] In its place, Congress should give the Fed a mandate with the single goal of achieving monetary neutrality by stabilizing overall spending in the economy.[2] Maintaining a reasonable growth path for total spending—often referred to as nominal gross domestic product (NGDP) level targeting—is the best way to achieve monetary neutrality because it requires the Fed to consistently respond to changes in the amount of money people need.

Money Supply, Money Demand, and Total Spending

In the modern era, monetary policy consists of the monetary authority, such as a central bank, managing the amount of money in an economy to promote economic growth. For instance, to speed up economic activity, the Federal Reserve lowers its target interest rate (loosens its policy stance) to induce banks to create (lend) more money. Conversely, the Fed raises its target interest rate (tightens its policy stance) to encourage banks to pull back on lending, thus slowing the economy via less money.

Optimally, the central bank would maintain a neutral stance by supplying exactly the quantity of money people need. In other words, the central bank would loosen or tighten its policy stance to precisely offset corresponding changes in the demand for money. While this task may seem daunting, a central bank can approximate a neutral stance by relying on how changes in money demand show up in the economy.

The key is that an increase in money demand is revealed when people hold on to more of their money (maintaining larger idle balances), thus spending less on goods and services. Conversely, a decrease in the demand for money reveals itself when people spend more on goods and services rather than hold on to it. Thus, when their demand for money falls, people spend down idle cash balances. Put differently, when total spending in the economy rises, it signifies that the supply of money must be rising faster than the demand for money.[3] In contrast, when total spending in the economy falls, it indicates that the demand for money must be growing faster than the supply of money.

Most Central Banks Target Inflation

Clearly, a central bank can gauge whether there is too much money in the economy (relative to demand) by simply looking at what has happened to total spending. For this reason, the central bank can then determine if it needs to supply more or less money based on the direction of total spending. Still, because an individual's demand for money is his demand for a certain purchasing power of money (what that money can buy), prices can—and in modern central banking, do—play a key role in how central banks try to manage the relationship between money demand and supply.

One reason why central banks use inflation (the rate of growth in overall prices) to guide their monetary policy stance is that changes in the price level (a measure of overall prices) are equivalent to the purchasing power of money as it relates to *all* goods and services.[4] For instance, at any given price level, people may view $100 as the ideal balance of money to hold. If, however, all prices in the economy drop by half, $50 will purchase the same amount of goods. As a result, people will not need as much money to maintain their level of purchases.

1. The Fed is typically assumed to operate a dual mandate of price stability and maximum employment, but the legislative mandate actually deals with three economic variables: prices, employment, and interest rates. See Norbert J. Michel, "The Fed at 100: A Primer on Monetary Policy," Heritage Foundation *Backgrounder* No. 2876, January 29, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2876.pdf. It is beyond the scope of the present *Backgrounder*, but Congress should also remove the Fed's financial stability mandates. See Norbert J. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2900.pdf.
2. This policy is similar to stabilizing aggregate demand, however, through monetary policy, which is much more responsive to macroeconomic changes than fiscal policy.
3. Unless otherwise noted, all references to *total spending* refer to total *nominal* spending rather than inflation-adjusted (real) spending.
4. Inflation targeting is typically undertaken to ensure some degree of "low and stable inflation" (on average, over the long run), but the above discussion applies equally well to the policy of stabilizing the price level at zero inflation. In 2012, for the first time in its history, the Federal Reserve set an official inflation target of 2 percent. See Kevin L. Kliesen, "Is the Fed's Definition of Price Stability Evolving?" Federal Reserve Bank of St. Louis *Economic Synopses* No. 33, 2010, https://research.stlouisfed.org/publications/es/10/ES1033.pdf (accessed March 2, 2019), and Jonathan Spicer, "In Historic Shift, Fed Sets Inflation Target," Reuters, January 25, 2012, https://www.reuters.com/article/us-usa-fed-inflation-target-idUSTRE80O25C20120125 (accessed March 2, 2019).

Therefore, instead of targeting the amount of overall spending in the economy, the central bank could try to address shortages or surpluses of money by trying to influence the price level. While most modern central banks do try to stabilize prices using an inflation target, there are very good reasons why they should, instead, try to stabilize the economy's total spending.[5]

Targeting Total Spending: The Best Way to Approximate Neutrality

One danger with a central bank trying to stabilize the price level is that the central bank has no particularly good price-setting powers. Monetary policy is a very blunt instrument in that the central bank has very little control over where additions to the money supply are spent. An inflation-targeting central bank, therefore, runs the risk of causing some goods' prices to no longer reflect their true scarcity at any given point in time. If, for instance, the Fed tries to grow the price level at 2 percent each year, it could mask the underlying conditions that some prices would otherwise signal to buyers and sellers.[6]

A particular problem with inflation targeting is that it requires the central bank to intervene when the economy is hit with important changes in the supply chain, such as productivity improvements or swings in trade. When productivity increases (a positive supply shock), businesses produce more goods and services because their costs of production decline. In such a case, it is perfectly natural—and beneficial for consumers—that businesses reduce their prices, ultimately decreasing the price level. An inflation-targeting central bank would, however, try to increase the price level in the face of this productivity increase for the sake of stabilizing prices. To the extent that it succeeds, this policy would prevent people from enjoying the benefits of higher productivity and lower prices.

Conversely, damaging swings in trade, such as the oil embargo in the 1970s, lead to higher prices due to fewer goods and services in the economy. In this case (a negative supply shock), an inflation-targeting central bank would be in the unenviable position of trying to lower the rate of inflation by decreasing the amount of money in the economy. Naturally, shrinking the money supply in such a case would starve the economy even further. In other words, by pursuing price stability in the face of a negative supply shock, the central bank would provide even less money to purchase even scarcer items, thus making it more difficult for people to buy the goods and services they need.

Hence, in the face of these types of supply-driven changes in the economy, an inflation-targeting central bank always pushes against the natural market forces that drive price changes. One way for the central bank to avoid this problem is to target total spending instead of inflation. Such a policy would permit the price level to fall in the face of positive supply shocks and to rise in the face of negative supply shocks, allowing prices to more accurately reflect their true relative scarcities.[7] Targeting total spending also has a practical advantage over inflation targeting because it is often impossible for a central bank to determine whether shocks are supply driven or demand driven until long after the fact.[8] For all of these reasons, targeting total spending is superior to targeting inflation.

5. For a definitive account, see George Selgin, *Less Than Zero: The Case for a Falling Price Level in a Growing Economy* (Washington, DC: Cato Institute, [1997] 2018).

6. Strictly speaking, in the absence of productivity changes, inflation targeting and nominal spending targeting would produce equivalent macroeconomic outcomes. However, when productivity changes, output prices relative to those of inputs change. Therefore, a central bank that targets nominal spending would better accommodate these relative price changes than one that tries to stabilize prices. See Selgin, *Less Than Zero*, pp. 21–54.

7. See, for example, George Selgin, David Beckworth, and Berrak Bahadir, "The Productivity Gap: Monetary Policy, the Subprime Boom, and the Post-2001 Productivity Surge," *Journal of Policy Modeling*, Vol. 37, No. 2 (March–April 2015), pp. 189–207.

8. Another practical advantage is that the central bank would no longer have to respond to estimates of potential output or the natural unemployment rate, unobservable variables. See David Beckworth, "The Knowledge Problem in Monetary Policy: The Case for Nominal GDP Targeting," Mercatus on Policy, July 18, 2017 https://www.mercatus.org/publications/monetary-policy/knowledge-problem-monetary-policy (accessed March 2, 2019), and Scott Sumner, "Don't Target Unemployment," The Library of Economics and Liberty, May 5, 2017, https://www.econlib.org/archives/2017/05/dont_target_une.html (accessed March 4, 2019). Similarly, the central bank would no longer directly respond to changes in unemployment, a benefit because maximum employment is largely determined by non-monetary factors (see below). Finally, the central bank would no longer have to forecast productivity changes because it would explicitly *not* respond to such changes.

TEXTBOX 1

How Would a Monetary-Neutrality Rule Work?

A good way to implement a rule for monetary neutrality would be to require the Federal Reserve to maintain a reasonable growth path of overall spending in the economy. Including the growth path target is an important component of this mandate because it would require the Fed to make up for past "misses," meaning that the Fed will always try to return the level of nominal spending to its trend. The Fed could, for instance, announce that it will try to maintain a 5 percent growth trend for nominal gross domestic product (NGDP) or another measure of total spending.

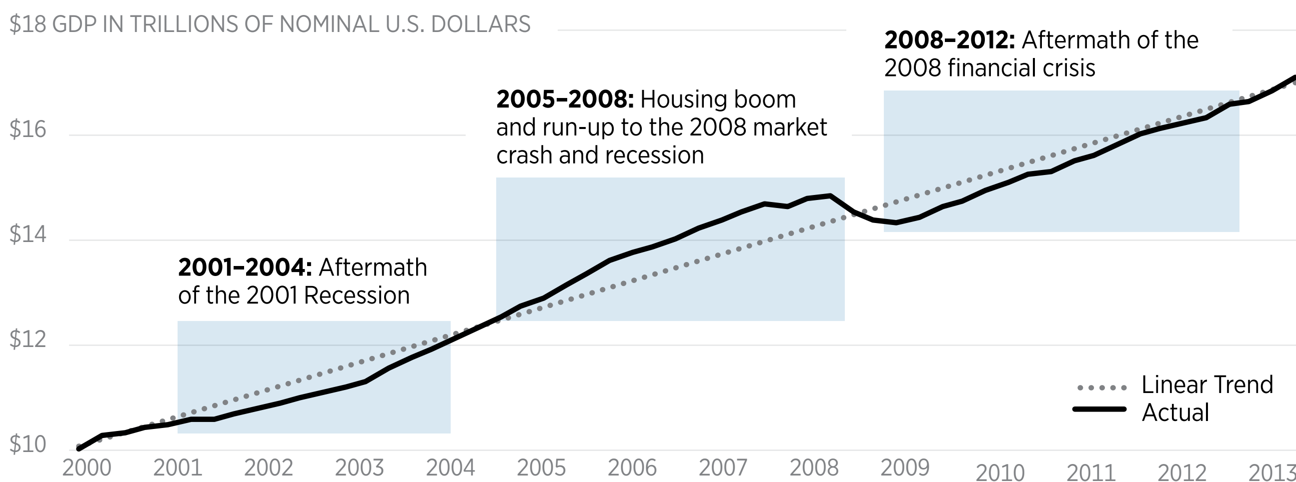
As shown in Chart 1, if NGDP comes in below the trend, as it did between 2001 and 2004, as well as between 2008 and 2012, the Fed would loosen its policy stance to offset the increase in money demand. That is, the Fed would try to expand the money supply to get total spending back to its 5 percent growth path. If, on the other hand, NGDP comes in above the trend, as it did between 2004 and 2008, the Fed would tighten its policy stance to offset the decrease in money demand. In other words, the Fed would try to decrease the money supply to get total spending back to its 5 percent target. The Fed could, as in this example, adjust its policy stance each quarter based on whether total spending was above or below trend in the previous quarter.

As a result, the Fed would always be pushing the level of total nominal spending toward the 5 percent growth path. This policy action does not, however, mean that the goal of monetary policy would be to maintain real (inflation-adjusted) economic growth of 5 percent. While the central bank would try to stabilize the growth of the total money value of output (nominal spending), the growth in actual output of goods and services in physical terms would likely differ from 5 percent because the price level would be allowed to rise and fall as productivity changes.

CHART 1

Achieving Monetary Neutrality

From 2000 to 2013, there were three unique peaks and dips above and below the linear trend that could have been mitigated had the Fed implemented a policy of monetary neutrality.



SOURCE: Federal Reserve Bank of St. Louis, "Gross Domestic Product," https://fred.stlouisfed.org/series/GDP (accessed April 3, 2019).

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The Benefits of Monetary Neutrality

The best way for a central bank to maintain monetary neutrality—supplying the amount of money the economy needs to keep moving, no more and no less—is to target total spending. Changes in total spending reveal the demand for money, thus making it easier for a central bank to supply the correct amount of money people need. Compared to its existing framework, the Federal Reserve would improve monetary policy outcomes if it were to begin targeting total spending. The benefits of such a change can be summarized as follows:[9]

- **The general public will more easily reap productivity gains.** As productivity improves, the costs of production decline, thus putting downward pressure on the prices of goods for sale (output prices) relative to the prices of inputs used to produce the goods. Targeting total spending is the best way to accommodate these price changes because a central bank cannot easily—if at all—use monetary policy to target only the prices of outputs. Targeting total spending also allows the price level (overall prices) to decline as productivity improves, thus allowing people to enjoy the benefits of more goods for sale at lower prices.

- **The central bank will respond correctly to negative supply shocks.** Negative supply shocks, such as a trade embargo or a trade war that severely limits the amount of goods in the economy, cause prices to rise. A central bank that targets total spending responds correctly in such a situation: It allows prices to rise, thus signaling that goods have become relatively scarce and that there is a strong demand for such goods. Should total spending fall as a result of the supply shock, the central bank would loosen its stance, thus increasing the amount of money in the economy. This policy action provides the money people need to maintain their level of spending in the face of the supply shock.

- **The central bank will promote ideal conditions for maximum employment.** According to the Fed, the "maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the job market. These factors may change over time and may not be directly measurable."[10] Because nonmonetary factors determine maximum employment, and because these factors are difficult (if not impossible) to measure, it is better for a central bank to focus on variables that it can directly measure and that are determined by monetary factors. Total spending is just such a variable—it is directly measureable, and monetary policy directly affects it. Moreover, keeping the level of total spending on a stable trend helps to smooth out economic downturns and avoid artificial booms, thus fostering the economic conditions that are most conducive to maximum employment. Separately, when employment falls *and* inflation rises, an inflation-targeting central bank is faced with tightening its policy stance in an already slowing economy, thus worsening the economic downturn and increasing unemployment.[11] A central bank that targets total spending avoids this policy error and focuses, instead, on stabilizing the overall economy in order to promote the ideal conditions for maximum employment.

- **The public will more easily understand how the central bank conducts monetary policy.** Targeting total spending provides clear signals to a central bank, allowing it to change its policy stance with minimal information problems. A central bank simply loosens its stance when total spending falls, and tightens when total spending rises. It avoids all of the information problems associated

9. Economic arguments for targeting total spending date to at least the 1800s. See George Selgin, "The 'Productivity Norm' Versus Zero Inflation in the History of Economic Thought," *History of Political Economy*, Vol. 27, No. 4 (1995), pp. 705–735. For a list of criticisms of targeting total spending, see Scott Sumner and Ethan Roberts, "The Promise of Nominal GDP Targeting," Mercatus, 2018, pp. 11–13, https://www.mercatus.org/system/files/sumner-nominal-gdp-primer-mercatus-v1.pdf (accessed March 31, 2019).

10. Federal Reserve Board of Governors, "FAQs: What Are the Federal Reserve's Objectives in Conducting Monetary Policy?" March 20, 2019, https://www.federalreserve.gov/faqs/money_12848.htm (accessed March 31, 2019).

11. The most recent example of such a problem is during the beginning of the 2008 financial crisis. See Matthew Obrien, "How the Fed Let the World Blow Up in 2008," *The Atlantic*, February 26, 2014, https://www.theatlantic.com/business/archive/2014/02/how-the-fed-let-the-world-blow-up-in-2008/284054/ (accessed March 31, 2019).

with inflation targeting, such as estimating the *potential output* of an economy (an unobservable variable), defining maximum employment, forecasting the productivity of the economy, or determining whether price-level changes were supply- or demand-driven (a virtually impossible task until long after the fact). This new framework would greatly improve the transparency of monetary policy for the general public.

Recommendations

A 1977 amendment to the Federal Reserve Act established what is generally referred to as the Federal Reserve's "dual mandate" and the monetary objectives of the Federal Reserve's Board of Governors and Federal Open Market Committee:

> 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.[12]

Congress should replace the Fed's existing statutory mandate with the single goal of achieving monetary neutrality through targeting overall spending in the economy.[13] For example, the Fed's new single mandate could read as follows: *The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain a reasonable growth path of overall spending in the economy, so as to achieve a neutral monetary policy.*

Implementing such a mandate would still leave the Fed with the discretion to choose from one of several aggregate statistics, such as total spending or final sales. Including the growth-path target is an important component of this mandate because it would commit the Fed to making up for past "misses," meaning that the Fed will always try to return the level of nominal spending to its trend. This feature of the mandate would bolster the public's belief that the Fed will try to stabilize total overall spending, thus anchoring people's expectations for U.S. monetary policy.[14]

Conclusion

Targeting total spending is the best way for the Federal Reserve to maintain monetary neutrality—supplying the amount of money the economy needs to keep moving, no more and no less. A central bank that targets total spending has the best chance of achieving monetary neutrality because it effectively requires the central bank to respond to changes in the demand for money. This framework would be superior to inflation targeting because it would allow prices to better reflect goods' actual scarcities, particularly in the face of productivity changes, and because it would avoid major information problems faced by inflation-targeting central banks.

Focusing on stabilizing total spending would also be an improvement over inflation targeting because it would allow the price level to fall in the face of positive supply shocks and to rise in the face of negative supply shocks. Given the existing centrally managed fiat money framework in the U.S., Congress can greatly improve monetary policy by replacing the Federal Reserve's dual mandate with the single goal of achieving monetary neutrality through targeting overall spending in the economy.

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12. Congress added this language to the Federal Reserve Act through Section 202 of Public Law 95–188 (November 16, 1977).
13. It is beyond the scope of this *Backgrounder*, but Congress should also curb the Fed's emergency lending powers by either eliminating them or requiring the Fed to reverse all aspects of such programs shortly after they are created, as well as curb the Fed's ability to permanently increase its balance sheet during such emergencies. See Norbert J. Michel, "Dodd–Frank's Title XI Does Not End Federal Reserve Bailouts," Heritage Foundation *Backgrounder* No. 3060, September 29, 2015, https://www.heritage.org/markets-and-finance/report/dodd-franks-title-xi-does-not-end-federal-reserve-bailouts, and Norbert J. Michel, "The Crisis Is Over: It Is Time to End Experimental Monetary Policy," Heritage Foundation *Backgrounder* No. 3265, November 9, 2017 https://www.heritage.org/monetary-policy/report/the-crisis-over-it-time-end-experimental-monetary-policy.
14. A growth-rate target would not require the Fed to make up for previous "misses" in this manner. See Scott Sumner, "The Case for Nominal GDP Targeting," Mercatus, October 23, 2012, https://www.mercatus.org/publication/case-nominal-gdp-targeting (accessed March 14, 2019).