A Time of Testing

Executive Summary

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A Time of Testing: Executive Summary

In 1979, Paul Volcker, then Chairman of the Federal Reserve Board of Governors, said that "this is a time of testing—a testing not only of our capacity collectively to reach coherent and intelligent policies, but *to stick with them*"[1] [italics mine]. My theme in this talk is that his powerful phrase applies with equal force to our current monetary policy situation. In 1979, Chairman Volcker was referring to the need to deal with ongoing high inflation. In my talk today, I will be referring to the need to deal with ongoing low employment.

The recovery in the U.S. labor market continues to be painfully slow. As a consequence, the condition of the labor market remains disturbingly weak, representing considerable hardship for a large number of Americans and a significant waste of resources for the national economy. Fortunately, there is good news: The low levels of inflation realizations and medium-term inflation expectations—both notably below the FOMC's target inflation rate of 2 percent per year—demonstrate that there is considerable monetary policy capacity to provide much needed stimulus to the labor market.

How best to deploy that capacity? I argue in this talk that we can learn a lot about the answer to this question by looking back to 1979. At that time, the perception that monetary policymakers could not (or would not) address the problem of high inflation was actually a key part of the problem facing the FOMC. Faced with this challenging issue, the FOMC followed what I would term *goal-oriented* monetary policy. This approach had two parts. First, the Committee formulated and communicated a clear goal: It intended to bring inflation down as quickly as possible. Second, on an ongoing basis, the Committee did whatever it took to achieve that goal, even if those actions had short-term economic costs. By following a goal-oriented policy, communications and actions worked together in a powerful fashion in bringing down both inflation and inflation expectations.

I see key parallels between the economic situation in 2013 and the situation in 1979. The FOMC again faces a challenging macroeconomic problem—stubbornly low employment this time instead of stubbornly high inflation. There is again a widespread perception that monetary policymakers lack either the tools or the will to solve this problem. And the perception of monetary policy ineffectiveness is itself a key factor in generating the current poor economic performance. Given the parallels between 1979 and 2013, I believe that a goal-oriented approach would be useful again.

The FOMC's goal should be to return employment to its maximal level as rapidly as it can, while still keeping inflation close to, although possibly temporarily above, the target of 2 percent. But it is not enough to formulate or communicate a goal. The Committee has to stick to its formulated approach—that is, it must do whatever it takes to achieve its communicated goal. Doing whatever it takes in the next few years will mean that the FOMC is willing to use *any* of its congressionally authorized tools to achieve the goal of higher employment, no matter how unconventional those tools might be.

A goal-oriented approach to monetary policy greatly reduced inflation in the early 1980s. Adopting such an approach in our own time would improve labor market outcomes.

[1] Volcker, Paul A. 1979. "A Time of Testing." Remarks before the American Bankers Association, New Orleans, La., Oct. 9, p. 4. Online at fraser.stlouisfed.org/docs/historical/volcker/Volcker_19791009.pdf.