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The Federal Reserve and the European Central Bank: a theoretical comparison of their legislative mandates

Abstract: In academic and policy circles, the assumption is often made that the Fed and the European Central Bank (ECB) have a perfectly identical understanding of what monetary policy can achieve and they follow the same policy strategy. This assumption slots uncomfortably with the different legislative mandates of the Fed and the ECB. Drawing on a critical analysis of the “new consensus” view in macroeconomics and its policy recommendations, this paper argues that the dual mandate of the Fed allows for a less restrictive set of theoretical assumptions than the single mandate of the ECB, and, for this reason, has to be preferred.

Key words: ECB, endogenous money, Fed, monetary policy, new consensus.

A few years ago, the Journal of Post Keynesian Economics (Vol. 24, No. 4, 2002, pp. 503–607) published a set of papers that were presented at the autumn 2001 meeting of the Post Keynesian Economics Study Group (PKESG). The topic of the meeting was monetary policy in an endogenous money world. The introductory paper to the meeting discussed the modern relevance of the endogenous money theory (Fontana, 2002). Endogenous money theory has a well-established tradition in Post Keynesian economics (e.g., Moore, 1988). It can be claimed that the endogenous money proposition that the stock of money in a country is determined by the demand for bank credit, and the latter originates in

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the needs of firms and consumers for financing productive and speculative activities, is today one of the main cornerstones of Post Keynesian economics, and heterodox economics more generally (e.g., Fontana, 2004).

The introductory paper to the symposium pointed out two critical issues with the endogenous money literature. First, with noteworthy exceptions (e.g., Lavoie, 1996), there were few contributions on the policy implications that could be derived from the endogenous money theory. Second, the past decade had seen two important changes in mainstream economics that had gone completely unnoticed to endogenous money theorists: (1) an upgrading of monetary policy at the expense of fiscal policy, and (2) the replacement of the monetarist credo for monetary aggregates targeting strategies with the “new consensus” support for inflation targeting strategies. As a result of these changes, in modern days, stabilization policy mainly means monetary policy in the form of aggregate demand fine-tuning through interest rate management with a view to achieve price stability. Importantly, having made the short-run interest rate the operative tool of monetary policy, mainstream economics now implicitly treats the stock of money in a country as an endogenous variable. Endogenous money theorists had thus missed some important advances in mainstream theory and policy, which had made some of their most popular critiques of the monetarist theory of exogenous money out of date, or at least in urgent need of revision.

The symposium papers in *JPKE* made the case for tackling head-on the two critical issues discussed above. The plea did not go unanswered. In the past three or four years, several journal papers have explored the topic of monetary policy in an endogenous money framework (e.g., Arestis and Sawyer, 2006; Palley, 2005). Similarly, several papers and books have been written to discuss the upgrade in the economic discipline, and policy circles, of monetary policy at the expense of fiscal policy (e.g., Arestis and Sawyer, 2004; Lavoie and Seccareccia, 2004) as well as the controversial issue of what is the nature and meaning of the endogenous money proposition in the “new consensus” and Post Keynesian approaches (e.g., Fontana and Palacio-Vera, 2006; Lavoie, 2006). This paper continues in the tradition of the original 2002 symposium papers in *JPKE*, by considering the legislative mandate for monetary policy of the two most prominent central banks in the world—namely, the Fed and the European Central Bank (ECB).

In academic and policy circles, the assumption is often made that the Fed and the ECB have a perfectly identical understanding of what monetary policy can achieve—namely, long-run price stability—and they
follow the same policy strategy. This assumption sits rather uncomfortably with their different legislative mandates. The Fed has the dual mandate of price stability and maximum employment, whereas the ECB has the single mandate of price stability. If the Fed and the ECB really follow the same policy strategy, it is only natural to ask to what degree their different legislative mandates inform their monetary policy strategies. Moving from the practice to the theory of modern monetary policy, how do the dual mandate and the single mandate compare in terms of being able to deal with alternative theoretical hypotheses about the long-run effects of monetary policy? This paper argues that an answer to these questions is essential for evaluating not only recent performances but also future policy actions of the Fed and the ECB.

**Institutional features of the Fed and the ECB**

*Do central banks matter?*

Central banks have a long history going back to the seventeenth-century creation of the Swedish Riksbank and the Bank of England. However, their number did not change for a long time. At the time of the creation of the U.S. central bank, the Federal Reserve System (Fed), in 1913, there were no more than 20 central banks. It was only after the end of World War II, and the beginning of the process of decolonization, that the number of central banks rose rapidly, topping in 1998, when the ECB was established, at 173 central banks (Pollard, 2003). Two of the most prominent institutions of this large group of banks are the central banks of the United States and of the euro area. Together the Fed and the ECB cover a geographic area that accounts for 37 percent of world output (IMF, 2002). In the past few years, both central banks have achieved prominent notoriety on the world scene for their similar performances. The Fed and the ECB have been praised for having sustained a low inflation environment in the United States and the European Union, respectively:1

Monetary theory and policy have been revolutionized in the two decades since the Federal Reserve moved in October 1979 to stabilize inflation and bring it down. . . . The decisive and revolutionary factor was

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1 Strictly speaking, the ECB has actually often failed to meet its inflation target, albeit by a narrow margin (see Sardoni and Wray, 2006, this issue).
the demonstration that monetary policy has the power to acquire and maintain credibility for low inflation so as to improve the stability of both inflation and output relative to potential. (Goodfriend, 2005, p. 258)

The report so far on the ECB is of a new institution that has faced numerous challenges head on and come out only mildly bruised. It is difficult to see how things could have come out better than they have. (Cecchetti and O’Sullivan, 2003, p. 41)

These endorsing quotations of recent policies by the Fed and ECB are extraordinarily silent on a couple of important assumptions behind these acclaimed “successful” performances. First, having the Fed and the ECB being assimilated for their supposed implicit or explicit adoption of an inflation targeting strategy, and having the United States and the euro area achieve low levels of inflation, the apparently innocuous assumption has been made that the Fed and the ECB have done a great job in reducing inflation. Second, against what some politicians, practitioners, and academics may say (e.g., Galbraith, 2002), the assumption has been made that both central banks have a perfectly identical understanding of the long-run effects of monetary policy—namely, price stability—and they follow the same policy strategy. In short, differences in the institutional structures of the Fed and the ECB do not matter for policy outcomes, and it is only natural to make the assumption that the two most prominent central banks can be treated in the same way (Enderlein, 2005).

The assumption that the Fed and the ECB have done a great job in maintaining a low-inflation environment in the United States and the euro area is not discussed in the remainder of the paper. However, readers should not consider it an innocuous or trivial assumption. In a recent paper, Ball and Sheridan (2005) discussed it, and they provided plenty of warnings against its adoption. Comparing seven Organization for Economic Cooperation and Development (OECD) inflation targeter countries against 13 nontargeter countries, Ball and Sheridan conclude that there is no evidence that the adoption of inflation targeting strategies has improved the inflation performance of a country. In other words, surely the United States and the euro area now have low levels of inflation but so have several noninflation targeting countries. On this account, if the Fed and the ECB have to be congratulated, a low level of inflation would not do it. Their performance has to be evaluated against some other criteria. This consideration leads to a discussion of the second assumption behind the endorsing quotes discussed above—namely, that institutional differences between the Fed and the ECB do not matter for their policy strategies. The argument goes that for all their different
historical origins and organizational structures, the two most prominent central banks in the world are strikingly similar in their policy approach.\(^2\) The next section looks closely at one particular institutional difference between the Fed and the ECB—namely, their legislative mandate—and asks if it matters for their monetary policy strategies.

**The legislative mandate for monetary policy: dual mandate versus single mandate**

The Fed was established with the Federal Reserve Act of 1913. At the time, macroeconomic policy was poorly understood, and for this reason, the founding act of the U.S. central bank did not include any macroeconomic goal. It simply required the Fed to serve as a lender of last resort in order to avoid the financial panic and the collapse of many banks, which frequently happened in the late nineteenth century. Things changed significantly with the Employment Act of 1946, which required the federal government, including the Fed, to promote maximum levels of employment and production. In 1977, the legislative mandate of the Fed was again amended by specifying as macroeconomic goals for monetary policy maximum employment, price stability, and moderate long-term interest rates. Finally, the last change to the legislative mandate of the Fed came with the Full Employment and Balanced Growth Act of 1978—the Humphrey–Hawkins Act, named after its sponsors, Senator Hubert Humphrey and Representative Augustus Hawkins. Section 2A of the Act reads as follows:

> The Board of Governors of the Federal Reserve System and the Federal Open Market Committee [FOMC] 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.

It is worth adding that because the difference between the nominal and the real interest rate is the inflation rate, stable prices will typically result in moderate long-term interest rates. For this reason, the Humphrey–Hawkins Act is usually interpreted as specifying for the Fed the dual legislative mandate of price stability and maximum employment.

\(^2\) For a discussion of the institutional features of the Fed and the ECB, see Cecchetti and O’Sullivan (2003), Judd and Rudebusch (1999), and especially Pollard (2003).
The origin of the ECB and of its legislative mandate for monetary policy is much simpler. The original Treaty of Rome that created, in 1957, the European Economic Community (EEC), mentioned the coordination of monetary and fiscal policy in order to improve the functioning of the customs union between the member countries of the EEC. This was followed first, in 1970, by the Werner report and then, in 1989, by the Delors report, both advocating a three-stage movement to economic and monetary union within a decade. In 1991, an agreement on changes to the Treaty of Rome was passed in order to attain the much-recommended economic and monetary union. This agreement, the Maastricht Treaty, named after the Dutch town where it was signed, came into effect in 1993 and finally led, in June 1998, to the creation of the European System of Central Banks (ESCB), which consisted of the ECB and the national banks of the European Union. Article 105(1) of the Treaty establishing the EEC as amended by the Maastricht Treaty gives the ECB the following mandate:

The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2.

And Article 2 of the Treaty reads as follows:

The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities referred to in Articles 3 and 4, to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States.

It is thus clear that, in contrast with the Humphrey–Hawkins Act, which maintains that price stability and maximum employment are policy objectives on equal footing, Article 105(1) of the Treaty has established a hierarchical position for price stability. But, does this legislative difference matter for the actual monetary policy strategies at the Fed and the ECB? In the previous section, it was argued that, according to a recent paper by Ball and Sheridan (2005), recent statistics on the inflation per-
formance of a country do not really tell much in terms of its monetary policy stance. At a recent gathering to celebrate the success of the Fed over the past 25 years, Ball (2005) returned to the issue. Table 1 confirms his previous results.

By comparing the inflation rates in 1979 and 2003 for 18 developed countries, Table 1 shows that, despite their initially different values, all inflation rates have now converged around 2–3 percent. On this account, therefore, most central banks have done very well in terms of inflation performance. Different legislative mandates do not seem to have made any significant difference. However, this conclusion is challenged by Table 2.

Table 2 shows three summary statistics for unemployment for the same 18 developed countries in 1984–2003—namely, in the 20 years since the end of the Volcker disinflation experiment in the United States. In the first pair of columns of Table 2, countries are ranked according to their average level of unemployment; in the second set of columns according to the standard deviation of annual employment, a measure of the volatility of unemployment; and in the final pair of columns, according to the highest annual rate of unemployment, a statistic trying to capture the success of a central bank in avoiding deep recessions. With the

### Table 1

CPI inflation (percent) in 1979 and 1983 for 18 developed countries

<table>
<thead>
<tr>
<th>Country</th>
<th>1979</th>
<th>1983</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portugal</td>
<td>23.5</td>
<td>3.3</td>
<td>–20.2</td>
</tr>
<tr>
<td>Spain</td>
<td>15.7</td>
<td>3.0</td>
<td>–12.7</td>
</tr>
<tr>
<td>Italy</td>
<td>14.6</td>
<td>2.7</td>
<td>–11.9</td>
</tr>
<tr>
<td>New Zealand</td>
<td>13.7</td>
<td>1.8</td>
<td>–11.9</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>13.5</td>
<td>2.9</td>
<td>–10.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>13.2</td>
<td>3.5</td>
<td>–9.7</td>
</tr>
<tr>
<td>United States</td>
<td>11.3</td>
<td>2.3</td>
<td>–9.0</td>
</tr>
<tr>
<td>France</td>
<td>10.7</td>
<td>2.1</td>
<td>–8.6</td>
</tr>
<tr>
<td>Denmark</td>
<td>9.6</td>
<td>2.1</td>
<td>–7.5</td>
</tr>
<tr>
<td>Finland</td>
<td>7.5</td>
<td>0.9</td>
<td>–6.6</td>
</tr>
<tr>
<td>Canada</td>
<td>9.1</td>
<td>2.8</td>
<td>–6.3</td>
</tr>
<tr>
<td>Australia</td>
<td>9.1</td>
<td>2.8</td>
<td>–6.3</td>
</tr>
<tr>
<td>Sweden</td>
<td>7.2</td>
<td>1.9</td>
<td>–5.3</td>
</tr>
<tr>
<td>Japan</td>
<td>3.7</td>
<td>–0.3</td>
<td>–4.0</td>
</tr>
<tr>
<td>Germany</td>
<td>4.1</td>
<td>1.1</td>
<td>–3.0</td>
</tr>
<tr>
<td>Belgium</td>
<td>4.5</td>
<td>1.6</td>
<td>–2.9</td>
</tr>
<tr>
<td>Norway</td>
<td>4.8</td>
<td>2.5</td>
<td>–2.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>4.2</td>
<td>2.1</td>
<td>–2.1</td>
</tr>
</tbody>
</table>

Table 2

Summary statistics for unemployment in 1984–2003 for 18 developed countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Mean</th>
<th>Country</th>
<th>Standard deviation</th>
<th>Country</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>3.3</td>
<td>United States</td>
<td>1.1</td>
<td>Japan</td>
<td>5.4</td>
</tr>
<tr>
<td>Norway</td>
<td>4.3</td>
<td>France</td>
<td>1.1</td>
<td>Norway</td>
<td>6.6</td>
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<tr>
<td>Sweden</td>
<td>5.4</td>
<td>Japan</td>
<td>1.1</td>
<td>United States</td>
<td>7.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5.6</td>
<td>Italy</td>
<td>1.3</td>
<td>Netherlands</td>
<td>8.9</td>
</tr>
<tr>
<td>United States</td>
<td>5.8</td>
<td>Belgium</td>
<td>1.4</td>
<td>Portugal</td>
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<tr>
<td>Portugal</td>
<td>6.1</td>
<td>Australia</td>
<td>1.4</td>
<td>Denmark</td>
<td>9.6</td>
</tr>
<tr>
<td>Denmark</td>
<td>6.3</td>
<td>Norway</td>
<td>1.5</td>
<td>Germany</td>
<td>9.7</td>
</tr>
<tr>
<td>New Zealand</td>
<td>6.6</td>
<td>Canada</td>
<td>1.5</td>
<td>Sweden</td>
<td>9.9</td>
</tr>
<tr>
<td>Germany</td>
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<td>Germany</td>
<td>1.5</td>
<td>New Zealand</td>
<td>10.4</td>
</tr>
<tr>
<td>Australia</td>
<td>7.9</td>
<td>Denmark</td>
<td>1.5</td>
<td>Australia</td>
<td>10.6</td>
</tr>
<tr>
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<tr>
<td>Belgium</td>
<td>8.5</td>
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<td>Canada</td>
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<tr>
<td>Finland</td>
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<tr>
<td>Italy</td>
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<td>France</td>
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<td>Ireland</td>
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<td>Finland</td>
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<td>Spain</td>
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<td>Ireland</td>
<td>4.8</td>
<td>Spain</td>
<td>19.8</td>
</tr>
</tbody>
</table>

Source: Ball (2005).
possible exceptions of Japan and Norway, the United States outperforms other countries in all three sets of columns. Taking together the statistics presented in Tables 1 and 2, Ball concludes that it is the experience of milder recessions that explains why the Fed, rather than other central banks around the world, is celebrating the past 25 years of monetary policy success. Putting it boldly, if the recent inflation performance of a country is not a good criterion to discriminate between central banks, the current unemployment performance seems to be a better test to evaluate different central banks and their monetary policy strategies. Drawing on a critical analysis of the “new consensus” view in macroeconomics, the sections that follow provide a theoretical justification for these different unemployment performances, and in so doing, they will make the case for a legislative dual mandate for monetary policy.

A theoretical evaluation of the Fed’s dual mandate and the ECB’s single mandate

The “new consensus” view and the conventional inflation targeting approach to monetary policy

The basic feature of modern stabilization policies across several countries, including the United States and the euro area, is the upgrading of monetary policy at the expense of fiscal policy, together with the monetary policy aim of achieving price stability. Central banks try to succeed in this aim by engaging in aggregate demand fine-tuning policies via changes in the short-term nominal interest rate with the implicit or explicit purpose of hitting a desired inflation target, which usually means a 2 percent rate of inflation. 3 Basically, in response to an increase in current or expected inflation, central banks increase the short-term nominal interest rate and, in this way, given short-term price and wage sluggishlyness, attempt to increase the short-term real interest rate. The purpose of this policy is to affect negatively the aggregate demand in the country, and possibly in this way to achieve the desired inflation target. This is the conventional inflation targeting approach to monetary policy derived from the “new consensus” view. Before discussing the theoretical justification for this policy approach, it is worth remembering that a positive rate of inflation of around 2 percent is consistent with a monetary policy goal of price stability. There are two main reasons for it.

3 This section draws on my joint work with Alfonso Palacio-Vera on the “new consensus” view (e.g., Fontana and Palacio-Vera, 2002; 2004; 2006).
First, inflation measurements are subject to errors, meaning that in order to avoid deflationary risks, central banks usually allow for a 1 percent margin of error in the definition of price stability. Second, central banks prefer to maintain some power to stir the economy through economic downturns by retaining the possibility of generating a negative real interest rate, which means an inflation rate of around 1 percent.

The theoretical justification for aggregate demand fine-tuning via changes in the short-term nominal interest rate is to be found in the central dogma of the “new consensus” view in macroeconomics—namely, the belief that changes in monetary policies affect only the aggregate demand side of the economy (Bayoumi and Sgherri, 2004). Again, in simple terms, the “new consensus” view subscribes to the classical dichotomy. Changes in the potential or natural level of output are due to exogenous changes in the components of aggregate supply, such as the rate of technical progress and the growth rate of the labor force. These changes are often explained in terms of increased flexibility of markets and are especially related to structural reforms of the labor market. By contrast, changes in the current level of output are due to changes in the components of aggregate demand, such as the investment and the consumption functions, which are assumed to be inversely related to changes in the real interest rates. Within this “new consensus” framework, an inflation rate different from the desired inflation target of around 2 percent means that there is a state of unbalance between the rates of change of aggregate demand and aggregate supply. Ideally, current output should grow in line with potential output. Therefore, if, for example, the current rate of inflation is above the inflation target, it means that aggregate demand is growing more than aggregate supply. The central bank should then attempt to regain control of the inflation rate by increasing the short-term nominal interest rate, and hence, curbing aggregate demand to a level consistent with the exogenously given aggregate supply. This also means that whenever restrictive monetary policy actions by the central bank are put in place, they are bound to produce negative effects on the level of current output and employment. However, these negative effects are short lived. They are aggregate demand effects, and therefore, they cannot produce any long-run consequence on the economy. For this reason, conventional inflation targeting central banks, such as the ECB, are left with the following types of criticism:

Once it is agreed that the Central Bank can control aggregate demand and unemployment through monetary policy we must come to the conclusion, however surprising and uncomfortable, that the behavior of unemployment we have observed, largely reflects the level intended by the
policy of the Central Bank. To understand the implications of this perhaps "inflammatory" statement, one must recall that since the mid '80s, European countries had de facto one Central Bank, being the Bundesbank. Thus to understand the sharp rise in unemployment one must understand what motivated the Bundesbank and now the ECB. . . . I have come to favour the guiding hypothesis . . . that the Bank's behavior has been driven by an obsessive fear of inflation and "benign neglect" for unemployment. (Modigliani, 2000, p. 10)

In the "new consensus" view, monetary policy produces real effects only in the short run, never in the long run. Thus, Modigliani may be right that the Bundesbank before, and the ECB later, have negatively affected the level of aggregate demand and employment in Europe. But these effects were simply one-off output losses associated with restrictive monetary policies put in place in Europe in order to control inflation. Neither the Bundesbank nor the ECB had, or will ever have, the power to affect the long-run level of employment in Europe. By extension, this means that Table 2, or at least the first set of columns of the table, is irrelevant for evaluating monetary policy. But, is this really the case?

Long-run aggregate demand effects and monetary policy

According to the "new consensus" view, the ECB, like any other conventional inflation targeting central bank, is theoretically sheltered from any serious criticism about the long-run performance of the euro area in terms of output and employment. The worst the ECB could do is fail to achieve price stability and, by doing so, the ECB will fail to eliminate or mitigate noise information for private and public decision makers (due to the difficulty of separating general from relative price changes), and hence fail to create the best conditions for economic growth. But, because the euro area, like many countries in the world, has actually experienced for some time a low rate of inflation, no serious criticism can be raised against the ECB or similar conventional inflation targeting central banks. At least, this is the case as long as the central dogma of the "new consensus" view is maintained, namely, that changes in the aggregate demand side have, if any, only a transitory impact on the degree of utilization of existing productive resources or their rate of expansion of over time. In other words, changes in aggregate demand do not produce any long-lasting effect on the aggregate supply. But, is this theoretical principle really a dogma? According to Fontana and Palacio-Vera (2006), there is plenty of research suggesting that persistent but nevertheless transitory changes in aggregate demand may have permanent effects on output and employment.
Fontana and Palacio-Vera (2006) discuss several sources of potential long-run effects of aggregate demand under three headings—demand-led growth models, hysteresis models, and multiple equilibria models. Demand-led growth models show that by acting upon the supply of labor, the availability of capital, and the level of technology in the economy, aggregate demand can alter the potential level of output and employment in a country (e.g., León-Ledesma and Thirwall, 2002; Setterfield, 2002). Aggregate demand also plays a significant long-run role in hysteresis models through two complementary theoretical hypotheses—the “labor market phenomena” hypothesis (Ball, 1999) and the “capital shortage” hypothesis (e.g., Arestis and Biefang-Frisancho Mariscal, 1997, 1998, 2000; Rowthorn, 1999). Basically, these models show that by curbing aggregate demand, central banks may permanently alter the labor market (e.g., via depreciation of skills and loss of work motivation in unemployed individuals) and the capital market (e.g., via lower level of investment and hence lower capital stock). As a result of these changes, when aggregate demand finally returns to its original level, the supply of labor and of capital does not bounce back (Sawyer, 2002). Finally, drawing on the existence of economic externalities, increasing returns to scale, and credit constraints, multiple equilibria models show that aggregate demand shocks may cause the economy to move between different long-run equilibrium levels of employment and output (e.g., Weitzman, 1982).

These long-run aggregate demand effects of monetary policy go a long way in explaining the positive comments on the Fed by Ball as well as the negative remarks by Modigliani against the Bundesbank and the ECB. By curbing aggregate demand, a central bank may not only reduce the inflation rate but it may also negatively affect the long-run level of output and employment of the country. This theoretical possibility is consistent with the experience of several European countries during the recessions of the 1980s and 1990s. Tight monetary policies may have kept the inflation rate at bay, but at the expense of persistent high unemployment rates. Similarly, by aggressively stimulating aggregate demand at the start of a recession, a central bank may be able to achieve low rates of inflation without paying the price of long-lasting high unemployment rates. Again, this theoretical possibility is consistent with the experience of the United States as summarized in Tables 1 and 2 (see also Romer and Romer, 1994).

Before moving to the next section for an evaluation of the legislative mandates of the Fed and the ECB, a note of warning on two alternative interpretations of the unemployment statistics presented in Table 2, col-
The interpretation favored in this paper has maintained that the low average unemployment level for 1984–2003 in the United States compared to, say, Italy, France, or Spain is consistent with the theoretical possibility that by engineering strong disinflationary policies, the central banks of these European countries might have caused negative effects on the aggregate supply, which then resulted in higher average unemployment than in the United States. More to the point, by easing aggressively at the beginning of recessions, the Fed may have actually caused positive effects on the aggregate supply and, hence, on the average unemployment level in the United States. An alternative and perfectly legitimate interpretation of the low average unemployment in the United States for 1984–2003 is that the country may have experienced some positive shocks to components of the aggregate supply, such as a productivity shock. The difference between the two interpretations is that in the former, the low average unemployment in the United States is the endogenous outcome of an increase in the aggregate supply due to an increase in the aggregate demand engineered by an aggressive easing of monetary policy. By contrast, in the latter interpretation, the low average unemployment in the United States is independent of Fed actions. It is simply the positive outcome of a fortunate exogenous shock to the economy. Again, for the sake of clarity, it should be added that the Fed has often been associated with the latter interpretation though the following quote from Fed Chairman Alan Greenspan seems to suggest a more complicated picture:

Let me just say very simply—this is really a repetition of what I’ve been saying in the past—that we have all been brought up to a greater or lesser extent on the presumption that the supply side is a very stable force. The assumption has been that the working-age population is increasing at a fairly predictable rate and that trend productivity is growing at a fairly stable one percent annual rate. So, the presumption has been that we could look at the supply side as an independent variable in the complex interaction of our equations. That presumption generally has been not challenged largely because it has worked. But what people around the table have been saying is that third-quarter growth has rebounded quite substantially. And indeed it has. So has productivity growth.

In my judgment our models fail to account appropriately for the interaction between the supply side and the demand side largely because historically it has not been necessary for them to do so. (Greenspan, 1999, pp. 46–47)\(^4\)

\(^4\) The author thanks Eric Tymoigne for providing this quotation.
The Fed versus the ECB: the case for a dual mandate for monetary policy

The previous sections discussed the “new consensus” view and its policy recommendations for a conventional inflation targeting central bank. In light of this discussion, is the dual mandate of the Fed to be preferred to the single mandate of the ECB, or vice versa? This is an interesting question for a variety of reasons, not least because there is an intense campaign in the United States to replace the legislative dual mandate of the Fed with a single mandate such as that of the ECB (Friedman, 2004; Mishkin, 2004).

This paper has argued against the dichotomy between aggregate demand and aggregate supply defended by the “new consensus” view. Following the precepts of the “new consensus” view, a conventional targeting central bank should start a disinflationary policy whenever the inflation rate is above the desired target rate. This paper has reviewed research on the log-run effects of aggregate demand to argue that such disinflationary policy could produce a permanent lower level of output and employment. More generally, this paper has maintained that, on the basis of this research, changes in aggregate demand caused by central banks’ manipulation of the short-run nominal interest rate may produce significant positive or negative long-run effects on the aggregate supply and, hence, on the growth rate of a country. This theoretical possibility opens the door for the long-run nonneutrality of monetary policy. If this is the case, what can be said in terms of discriminating between a dual and a single mandate? Should the Fed abandon its legislative mandate for price stability and maximum employment and adopt the ECB’s mandate for price stability? The answer is simply no.

The dual mandate of the Fed is more general than the single mandate of the ECB. A dual mandate for price stability and maximum employment allows for less restrictive theoretical assumptions than a single mandate for price stability. It can encompass a variety of theoretical principles including the now dominant “new consensus” view that monetary policy is neutral in the long run because aggregate demand never affects aggregate supply. Importantly, it can also encompass a broader view of macroeconomics that allows for the interaction between aggregate demand and aggregate supply and for the nonneutrality of monetary policy. It is thus the generality of the dual mandate that recommends it above the single mandate. This generality has allowed a margin of flexibility to the Fed that has been welcomed by several policy makers and economists alike:
I think that the U.S. economy has benefited from the flexibility that the Federal Reserve has derived by eschewing a formal inflation target. By flexibility I mean not frequent changes in long-term objectives but rather the freedom to deviate from long-term price stability, perhaps for a while. (Kohn, 2003, p. 7)

Some economists . . . believe that uncertainty, both about the current and likely state of the economy and about the effects of monetary policy on the economy, is so overwhelming that policymakers should be humble and focus on only one thing: inflation—which is what the Fed can undeniably control in the long run. This approach is often referred to as “strict inflation targeting.” But I, for one, am not a strict inflation targeter. I do not subscribe to the dismal conclusion of this approach. And—as far as policymakers go . . . the Federal Reserve Act is more optimistic: as you well know, the Federal Reserve is charged with assuring both maximum employment and price stability. . . . I have a hard time believing, for example, that the FOMC’s accommodative policy stance following the last recession has not helped support the subsequent recovery. . . . I think we can and should pay attention to both objectives. Furthermore, I would argue that the Fed has successfully done so over the past two decades. (Yellen, 2005, pp. 2–3)

Many central banks have followed the prescriptions of theory. They have kept policy tight, even during recessions. This behavior has produced long periods of high unemployment. The Fed’s approach to policy has been more balanced. It has tried to control both inflation and unemployment, and it has succeeded. Fortunately, the Fed has not learned modern theory too well (Ball, 2005, p. 268).

The dual mandate gives the freedom to central banks to interpret empirical data and economic theory in a flexible way. For some commentators, such as Ball, Kohn, and Yellen, the results of this freedom in the United States are under everyone’s scrutiny. The United States has achieved price stability, inflation expectations are low and stable, and recent economic recessions have been quite mild compared to other countries. This paper does not necessarily subscribe to this view. Many factors have contributed to the recent economic performance in the United States, among which the fiscal stimulus has surely been prominent. But, this paper does support the view that the generality of the dual mandate has allowed for a more positive role of the Fed to be played in the U.S. performance than has been the case of the ECB for the economic performance of the euro area. For this reason, this paper recommends that, in the near future, many more countries, and especially the ECB, will have the freedom of a dual mandate of price stability and maximum employment.
Conclusions

In academic and policy circles, the assumption is often made that the Fed and the ECB have a perfectly identical understanding of what monetary policy can achieve, namely, long-run price stability, and for this reason, they follow the same policy strategy. This assumption sits rather uncomfortably with the different historical origins and institutional features of the two central banks. This paper has focused on one institutional difference, namely, the legislative dual mandate for maximum employment and price stability of the Fed and the legislative single mandate for price stability of the ECB. Drawing on a critical analysis of the “new consensus” view in macroeconomics and its policy recommendations, this paper has argued that the dual mandate allows for a less restrictive set of theoretical assumptions than the single mandate, and for this reason, has to be preferred.

REFERENCES


