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RESEARCH SUMMARY

THE CASE FOR NOMINAL GDP TARGETING

With a dual mandate to achieve both price stability and high employment, the Federal Reserve (Fed) has traditionally relied on interest-rate targeting to achieve its goals. This interest-rate-targeting regime, sometimes compared to economist John Taylor's famous policy rule, worked relatively well during the "Great Moderation" between 1983 and 2007. However, monetary policy was not used effectively enough to prevent the recent "Great Recession" or to foster a robust recovery.

In a study for the Mercatus Center at George Mason University, Scott Sumner—now director of the Mercatus Center's Program on Monetary Policy—explains why the current interest-rate-targeting and inflation-targeting regime is inadequate and why the Fed should target nominal gross domestic product (NGDP) instead. Targeting NGDP—the sum of all nominal spending in the economy, or alternatively a nation's income—would have greatly reduced the severity of the Great Recession and eliminated the need for fiscal stimulus and bailouts. It would also ensure low inflation on average and milder business cycles.

To read the entire study and learn more about its author, see "The Case for Nominal GDP Targeting."

A BRIEF HISTORY OF MONETARY POLICY

Gold and silver were used as money for much of human history because of their scarcity and their retention of value over time. However, changes in the supply of or demand for gold under the gold standard caused price levels to fluctuate, sometimes dramatically. In the late 1920s and the 1930s, increased demand for gold and wage stickiness caused a massive drop in output and the high unemployment of the Great Depression.

In the period from 1979 to 1982, money supply targeting (i.e., targeting a metric of monetary assets such as cash plus bank deposits) was used as a means of combatting high inflation. After 1982, the Fed set interest rates in response to inflation changes (often following something close to the Taylor Rule). While this system worked well for more than two decades, it did not stop the Great Recession and the resulting high unemployment.

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The Fed's failure during the Great Recession can be explained by four related problems:

1) The Fed relied on past trends rather than on market forecasts about where the economy was headed.

2) The Fed relied on interest-rate targeting as the main monetary policy instrument. This became problematic when interest rates hit zero and the Fed was unable to cut them further, despite both unemployment and inflation remaining below target.

3) The Fed failed to engage in level targeting, which means making up for any recent under- or overshooting of the target path.

4) The Fed targeted inflation rather than NGDP.

THE CASE FOR NGDP TARGETING

There are several reasons, both theoretical and pragmatic, for adopting a nominal GDP or national income target:

- *An NGDP-targeting regime responds to changes (shocks) to both aggregate supply and aggregate demand.* Both NGDP targeting and inflation targeting respond to demand shocks by adjusting the money supply to offset any change in the velocity of money (the rate at which money passes from one holder to another). However, NGDP targeting also responds appropriately to a supply shock in any sector of the economy. If productivity surged, causing real GDP to rise faster than usual, such as during the 1990s tech boom or the housing boom shortly after 2000, then monetary policy would be used to keep NGDP growth stable, hence reducing inflation. Conversely, if velocity fell as it did during the 1930s and 2009, monetary policy would expand the money supply to offset the fall until the Fed's growth target for NGDP had been achieved. NGDP is also a relatively clear concept, whereas it is not clear which of the many types of price indices is the most appropriate target for policymakers.

- *NGDP targeting encourages sound fiscal policy and discourages unsound fiscal policy.* If the Fed kept NGDP growing along its target path, it would become clear that the Fed would offset any changes from fiscal policy aimed at boosting aggregate spending in the economy. Similarly, bailouts of supposedly "too big to fail" firms would be more difficult to justify. It would be clear that any spending on cars from a bailed-out auto company such as Chrysler would merely result in less spending elsewhere in the economy. The same logic would undermine arguments favoring bailouts of banks and other financial institutions. However, supply-side policy reforms could still boost real GDP, in which case inflation would slow.

- *NGDP targeting does not rely on interest rates.* Even if interest rates hit zero, the Fed would never be out of ammunition. It could engage in quantitative easing or even set negative interest rates (i.e., charge for deposits held at the Fed). And under an NGDP-targeting regime, interest rates would be unlikely to fall to zero.

- *NGDP targeting depoliticizes monetary policy*. The current dual mandate is ill-defined and allows each side of the political divide to argue whether money is too easy or too tight. NGDP targeting would provide more transparency about whether policy was overshooting or falling short, as a single, easily monitored variable would be the policy target.

A MORE TRANSPARENT AND MARKET-DRIVEN FED

An NGDP-targeting regime could also be more transparent and market-driven than the current interest-rate targeting regime. To further improve transparency, the Fed could engage in level targeting.

If the level target is 100 and the Fed only achieves a level of 99 in a given year, it must engage in monetary expansion in the following year to get back on the target path. To target the market forecast for NGDP, the Fed could establish an NGDP futures market. The basic idea is to set the monetary base at a level where the market expectation of future NGDP growth is right on target. The Fed would then buy or sell NGDP futures contracts to control the money supply, in order to offset changes in velocity.

CONCLUSION

Many economists are acutely sensitive to the very real dangers of high inflation, but shortfalls in nominal spending can occasionally be even more damaging. NGDP targeting generates a steady growth in spending and avoids the dangers of both high inflation and falling NGDP. It provides the best environment for free-market policies, depoliticizes monetary policy, and eliminates the need for fiscal stimulus and bailouts of politically connected firms during recessions. It is also a way to make the Fed more accountable and can be combined with a monetary policy. It is receiving increasing support from economists across the political spectrum, and is broadly consistent with the Fed's dual mandate.