Nominal GDP Targeting

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Recent months have witnessed an upsurge of interest in the idea that, to quote *The Economist* (2011), "… rather than directing monetary policy to hit inflation targets (as they have done for the past 20 years) central banks should take aim at nominal GDP (or NGDP)." That is, the idea is that central banks should conduct monetary policy so as to keep the growth rate of aggregate nominal spending at a specified numerical value. This value would equal the sum of the central bank's target inflation rate (say, 1.5% per annum) and the economy's long-run average rate of output (real GDP) growth (say, 3.0%). The belief of supporters of the suggestion is that successful achievement of this objective would yield the same long-run average inflation rate as would achievement of an inflation target of 1.5%, and also the same long-run growth of output, but would do so with a reduced volatility of output fluctuations.[1]

As one who published numerous academic papers over the years 1985-1999 that supported that suggestion, I greatly welcome this upsurge. I am a bit sorry that my writings always used the term "nominal income targeting," since a Google search on "nominal GDP targeting" does not lead to my papers, but of course I have no property rights at all to the basic idea, which was first developed, I believe, by the great British economist James Meade many years before his Nobel Prize lecture of 1977.[2] The recent upsurge has been led by Scott Sumner and other bloggers, who typically use the term nominal GDP targeting, which is more specific.[3] Actually, however, the basic idea is that monetary policy affects both inflation and real output by way of its influence on nominal aggregate demand, so one might want to focus upon, rather that nominal GDP, some other measure of aggregate nominal spending. One example is the measure favored by William Niskanen, "nominal final sales to domestic purchasers" (i.e, nominal gross domestic product plus net imports minus the change in private inventories).[4] A different type of departure from pure nominal GDP could be the use of a related measure that is available at a higher frequency, e.g., one based on the product of a producer (or consumer) price index and the industrial production index, both of which are available on a monthly basis. The feasibility of this type of approach refutes the possible objection that nominal GDP is available only at quarterly intervals, which might be judged as available too infrequently for practical policymaking.

The main issue, however, is *why* use of the rate of growth of some nominal spending measure would be better than use of the rate of growth of a broad price index (i.e., some inflation rate) as the crucial variable on which the central bank should focus. In that regard, a basic consideration is that inflation is not the only macro variable that the central bank wishes to influence in a productive manner. Output (and employment) also is of great concern, so it is desirable (as well as politically inevitable!) that the central bank will take this real variable into account in making its policy decisions. In fact, "inflation targeting" has come to mean, among central bankers as well as academics, a policy that focuses not only on inflation but also on measures such as the "output gap,"

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[1] These beliefs are based on the widely accepted concept of the "long-run neutrality of money."
[2] See Meade (1977). A prominent U.S. academic supporter was Robert Hall; see Hall (1984) and also Hall and Mankiw (1994). Tobin (1983) also mentioned, did not actively support, the strategy.
[3] Sumner's blog site is: www.themoneyillusion.com.
[4] See Niskanen (2009). He has been a consistent and insightful promoter of the approach.

that is, the difference between actual output and its "natural" value (which would be forthcoming if it were not for certain frictions, including primarily "price level stickiness," i.e., slow adjustment of prices to changes in macroeconomic conditions). To focus on nominal GDP growth is only one way of taking into account both inflation and real output considerations, but it is a simple, clean way of doing so. It also has the desirable feature that it gives the central bank an objective that is expressed entirely in nominal (i.e., monetary) terms.

It seems ironic then that, when academic economists suggested nominal income targeting to Federal Reserve officials in the 1980s, often the main objection put forth was that it would be difficult for the public to understand.[5] But it seems likely that it would be easier for the public to understand nominal GDP growth than a target that includes an unspecified weighted average of an inflation rate and some unreported major adjustment to take account of output and/or unemployment conditions. Indeed, I would argue that "total spending" in the economy is a way of describing nominal GDP that would make that concept at least as easy to understand by average citizens as "core inflation" or even CPI inflation.

But suppose that the central bank were to be explicit and clear about weights to be attached to target levels of inflation and output-gap variables separately. How would nominal income targeting compare with that type of inflation targeting substantively, i.e., in terms of results? Here one cannot be certain, but I find it plausible that movements in nominal spending growth would be more closely and reliably related to central bank policy actions—primarily open market sales and purchases—than would movements in inflation and output separately. If so, then the central bank that targets nominal GDP would not have to rely upon its models of the way in which nominal and real variables are related, that is, its model of the "Phillips curve" relationship. That is a significant advantage, because the Phillips curve relationship is the component of quantitative (econometric) macroeconomic models for which professional understanding and agreement is, by far, the weakest. Thus, if the central bank can manage nominal spending growth in a manner that does not involve conceptually the Phillips curve, it can conduct policy without use of that elusive relationship. By contrast, if it focuses on inflation and real GDP separately, or on inflation alone, it cannot possibly avoid its use.

The point of view expressed in the preceding discussion is somewhat reminiscent of Milton Friedman's approach to price-level determination, in which he famously depicts the central bank as choosing the supply of money in nominal terms while the private sector is choosing the quantity of money demanded in real terms. The interaction of these choices then determines the price level—see Friedman (1987, pp. 3-4). In the present application, the central bank determines the amount of spending in nominal terms, with the private sector's behavior determining how much of any change in spending will be in terms of (real) output changes and how much will be in (nominal) price level changes. Since the long-run average growth rate of private demand in real terms is due to growth of labor, capital, and technological progress—none of which will be strongly affected by the average inflation rate (according to almost universal

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[5] This statement is based on discussions at the time with Federal Reserve officials.

agreement among monetary/macro economists)—the central bank's choice then yields the desired (target) inflation rate on average.[6]

From the foregoing it can be seen that one issue that arises in discussions of nominal GDP targeting is whether the targets should be expressed in terms of "level" or "growth-rate" measures. For an example of the distinction, suppose that the chosen rate of growth of nominal GDP is 4.5% per year. Suppose that in some year, however, the central bank misses that target by a full percentage point on the high side, yielding 5.5% growth consisting of (for example) 3.0 percent inflation and 2.5% real growth. Should the central bank strive for the usual 4.5% growth in nominal GDP again in the following year? Or should it decrease its growth target to 4.0%, aiming thereby to be back at the original path for the nominal GDP level at the end of the next year? In other words, should the nominal GDP targets be set in terms of growth rates or growing levels? In the latter case, the disadvantage will be that policy that decreases nominal growth below its usual target value may be excessively restrictive, whereas the former case leaves open the possibility of cumulative misses in the same direction for a number of periods, i.e., it permits "base drift" away from the intended path. My position on this issue has been that keeping with the target growth rates will, if they are on average equal to the correct value over time, be unlikely to permit much departure from the planned path and so should probably be preferred. This is not at all a universal point of view, however, among nominal GDP supporters.

[6] Assuming, of course, that the central bank is correct in its estimate of the growth rate of real output.

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