Quarterly Report, December 2011

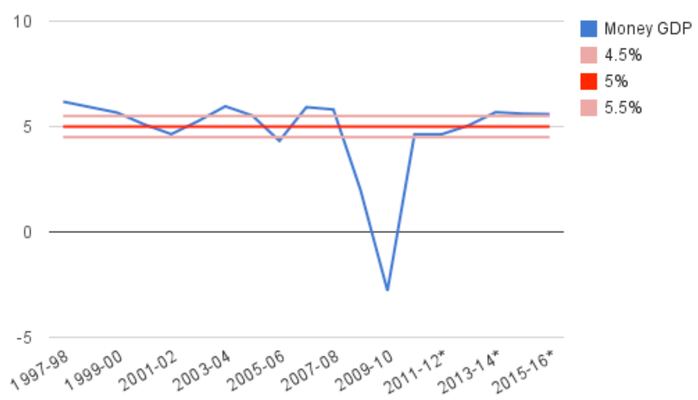
The perils of NGDP targeting

One of the main lessons of policymaker's inability to prevent and respond to the financial crisis is that inflation targeting has failed. Economists are increasingly questing how "great" and how "moderate" the "great moderation" really was, and are searching for alternative ways to conduct monetary policy. One idea that is becoming increasingly prominent is nominal income or NGDP targeting.[1] The basic idea is that in a desirable monetary environment the "total income stream" should remain stable.

The most famous proponent is Scott Sumner who deserves immense credit for being far ahead of the profession on this issue. Gradually the idea is gaining traction, and there is evidence that various central bankers are beginning to pay attention.

In ordinary times inflation tends to run at around 2%, and real GDP can be expected to grow at about 3%. Ergo, many advocates of NGDP targeting treat 5% as an appropriate growth rate. Indeed it is not beyond the realms of possibility that the Bank of England have this figure in the back of their mind when making interest rate decisions. Figure 1 uses the GDP deflator to show "money GDP" from 1997 through to 2016.[2]

Figure 1



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[1] See Scott Sumner, "Re-targeting the Fed" *National Affairs*, Issue 9 Fall 2011 [http://www.nationalaffairs.com/publications/detail/re-targeting-the-fed] and Scott Sumner, *The case for nominal GDP targeting*, Adam Smith Institute, April 2011 [http://www.adamsmith.org/research/reports/the-case-for-nominal-gdp-targeting]

[2] The forecasts through 2015/16 are the official ones, which should be treated with suspicion. The data comes from the Treasury: http://www.hm-treasury.gov.uk/data_gdp_fig.htm and the graphs were compiled prior to the Autumn Statement, 29 November 2011.

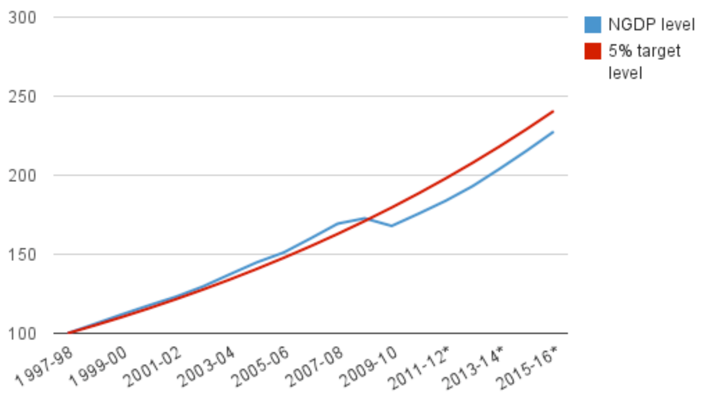
It is interesting to see how well behaved NGDP was during the "Great Moderation" – it stayed pretty close to 5% per year and rarely went outside a 4.5% - 5.5% band. Indeed one might be forgiven for thinking that the Bank of England was operating under an NGDP target rather than an inflation target given the asymmetric way in which CPI hovered around 2%. During this period some economists were suspicious over whether 2% was the real target, given that the Bank seemed far more willing to allow inflation to overshoot, as opposed to undershoot. But the interesting issue is what's guiding policy now? Inflation has been well above 2% for some time, and the Bank appear perfectly comfortable with it growing at 4%-5%. Perhaps this is because when real GDP is at 0%-1% it means that they are hitting an implicit NGDP target of 5%?

We do not believe that the Bank of England has truly abandoned its inflation target. Yet. But it is clear that their actions conflict with their public commitment to low inflation. Viewing policy decisions through the lens of NGDP targeting suggest that there is still a logic behind what they are doing.

Of course the stunning aspect of Figure 1 is the depth of the recession and the central banks' failure to prevent NGDP from collapsing. Superficially it appears as though they have found a way to correct this, since forecasts of NGDP are back "on track". However this ignores the fact that most advocates of NGP targeting want a level target, not a growth target.

Figure 2 shows the actual level of money GDP (i.e. NGDP) in blue, and what NGDP would be if it has grown by 5% per year since 1997.

Figure 2



This neatly shows how NGDP began running ahead of a 5% growth path prior to the credit crunch, and then retracted during the recent recession. Although it is back to a forecasted growth path of 5% it fails to catch up with where it "should" be. This is the "output gap" that so many economists and commentators are fond of, and is why NGDP advocates tend to argue that it should rise by *more* than 5% such that it gets back to the original path.

But notice how arbitrary the starting point of 1997 is. This is merely when the Bank of England were given operational independence. It is a subjective judgment. We could pick any date.

In her New York Times opinion editorial, in which she called for the US Federal Reserve to adopt NGDP targeting, Christina Romer said the following[3]:

> The Fed would start from some normal year — like 2007 — and say that nominal G.D.P. should have grown at 4 1/2 percent annually since then, and should keep growing at that pace. Because of the recession and the unusually low inflation in 2009 and 2010, nominal G.D.P. today is about 10 percent below that path. Adopting nominal G.D.P. targeting commits the Fed to eliminating this gap.

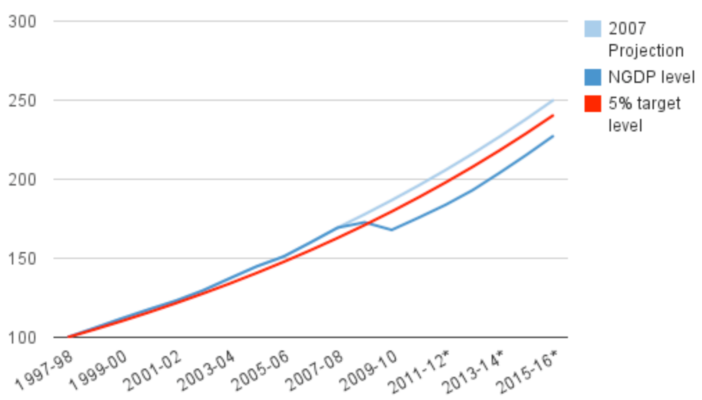
Allow me to repeat that:

> some normal year — like 2007 —

Come again?! Note how Romer uses the height of the previous boom as the definition of a "normal year". To economists with that viewed the economy as fundamentally sounds in 2007, and believe the recession is merely the result of bad monetary policy in 2008, this makes sense. But to economists that look at the structure of production, the capacity for malinvestment, the possibility for booms and busts - 2007 should be viewed as the final declaration of unbridled ecstasy and joy made by the office drunk at the Christmas party moments before he vomits into his own shoes and passes out. This was an economy growing beyond its natural rate that was on the verge of an inevitable recession.

But figure 3 takes Romer's advice seriously, and extrapolates a growth path from 2007.[4]

Figure 3



[3] "Dear Ben: It's Time for Your Volcker Moment", by Christina D. Romer, New York Times, October 29th 2011. [http://www.nytimes.com/2011/10/30/business/economy/ben-bernanke-needs-a-volcker-moment.html]

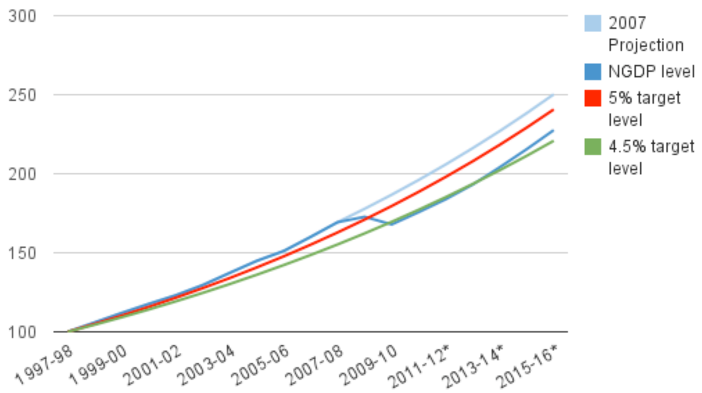
[4] Romer advocates a 4.5% NGDP path but for consistency we stick with a 5% figure.

Notice how the "output gap" widens, and the implications for expansionary monetary policy increases. If we rewrite history such that 2003-2007 was not a boom, and use 2007 as our benchmark, then although the dark blue and light blue lines are parallel, we are still way behind where we should be. But by this logic we should believe that since Usain Bolt can run 100 metres in under 10 seconds, he could run 600 metres in under a minute.

When criticising central banks the inevitable question is "what would you do?" and our simple answer is "we're not sure". The point isn't to say that 5% is too high, and that a lower rate would have made everything fine. We are uneasy with NGDP targeting being labelled a "Hayek Rule"[5] as if we've finally found the "Austrian" alternative to the Friedman, McCallum or Taylor rules. The insight is that central banking requires an epistemic burden on policymakers that it is impossible to live up to. *However*, we can still use the framework of NGDP targeting to make some useful points. Whilst many Austrian school economists recognise the Hayekian foundations of the concept, and the extent to which it is supposed to replicate how a free banking regime would behave, it could be viewed as a "less bad" alternative.[6] But this turns the discussion to the appropriate growth rate, with the argument being that anything above 2% is probably too high and likely to generate booms and busts.[7]

Figure 4 expands on the previous charts to add a 4.5% target level in green.

Figure 4



Even though this is just 0.5 percentage points lower than a 5% target, when extrapolated from 1997 it shows two things. Firstly, that the boom in 2003 – 2007 was even bigger than before, and secondly that the economy is forecast to have *already* got back to the trend rate of growth. In fact by 2013/14 we are

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[5] Marius Gustavson and Anthony Randazzo, "The Hayek Rule: A new monetary policy framework for the 21st century" *Reason Foundation*, November 9th 2010
[6] See Anthony J. Evans, "Forward Thinking", *Money Marketing*, May 26th 2011 [http://www.adamsmith.org/news/in-the-news/forward-thinking]
[7] See the exchange between George Selgin and Scott Sumner at Cato Unbound, in response to "The real problem was nominal", Scott Sumner, September 2009 [http://www.cato-unbound.org/2009/09/14/scott-sumner/the-real-problem-was-nominal/]

forecasted to be reinflating the next artificial boom, as once again we pursue economic growth at unsustainable levels.

You only need to believe that the optimal rate of NGDP growth is lower than 4.5% to therefore view present policy as being inflationary and dangerous. As Lars Christensen has pointed out if consumers and businesses were expecting NGDP to grow by 5% a year, it might not be wise to change that now. However the Bank of England are unable to publicly specify a target rate of NGDP. Indeed this is another downside to inflation targeting, because the Bank's communications are focused entirely on inflation expectations. But after spending so much time and effort getting them anchored, perhaps change is unavoidable, and it'd be worthwhile for a debate over NGDP targeting to take centre stage.

Kaleidic Economics is a business roundtable that meets each quarter in London. For more information: http://kaleidic.org

Editor: Anthony J. Evans, anthonyjevans@gmail.com

