Trends in Monetary Policy

NOMINAL GDP TARGETING

Introduction

It is certainly too soon to talk about regime change regarding the way monetary policy is generally conducted. Yet, in recent years, possibly influenced by the resilience of the Great Recession, a number of economists have begun to challenge the current orthodoxy in this area.

As is widely known, since 1990, a large number of countries, some formally, others without a formal announcement, have adopted an inflation targeting regime, which involves setting an explicit goal for inflation, which then becomes the top priority for monetary policy. Of late, though, some professional economists and, in particular, one acting central banker have criticized this policy framework and suggested that there are better alternatives. Rather than targeting an inflation rate, so goes the idea, the central bank should pursue an announced nominal GDP path. In principle, such a path would combine the potential growth rate of real GDP and the desired long-term inflation rate. If the economy operates with a high level of idle resources, this strategy would imply adopting sufficient monetary stimuli to push the nominal GDP towards the proposed path, within a reasonable non-specified time span. If the lower bound for the nominal interest rate has been reached, the central bank should expand money supply by printing money.

This is a system that has never been tested. And if it is true that its adoption may not be imminent, as remarked above, it is also true that the idea will be widely debated in the foreseeable future. In this respect, it is worth noting that a couple of measures recently undertaken by the Fed can be viewed as perfectly compatible with the spirit of the proposal. The motivation behind the option for those measures has to do with the slow pace of recovery after economic activity bottomed in mid-2009. And the basic idea is to somehow increase the weight given to unemployment in the central
bank’s reaction function. We have, then, more than one reason to discuss the subject in this article. And this is what we do next.

**Numerical Thresholds**

As is widely known, the system in place in the US is not inflation targeting, but the so-called dual regime, according to which the Fed is required to conduct monetary policy so as to obtain the maximum possible employment level and price stability. These are goals established by the US Congress and, in order to have any practical meaning, they need some sort of an interpretation by the policy makers. In any event, the fact of the matter is that, at least in recent times, many people (market analysts, professional economists, politicians, members of the government, etc.) started to view the Fed’s policy as tilted towards one of the formal objectives (price stability), in detriment of employment. This view may have gained some strength after January 2012, when the FOMC made explicit (for the first time) what their idea of price stability was. In the words of the press release issued at the end of the meeting held on January 25, “the Committee judges that inflation at the rate of 2 percent […] is most consistent over the long run with the Federal Reserve’s statutory mandate”, a statement which was misinterpreted by many as indicative of the adoption of the inflation targeting regime by the Fed. At the occasion, the FOMC opted for not specifying a fixed goal for employment (they gave only a range for the unemployment rate, between 5.2% and 6.0%), based on the reasoning that the maximum level of employment is largely determined by nonmonetary factors, and change over time. If one looks at the projections of inflation made by FOMC members at some of their formal meetings, from the recent crisis onward, one notices that they rarely go above the 2.0% level. This is probably reflection of the belief of the members of the Committee that the deleveraging process, still ongoing, and the large resource gap under which the American economy has been operating in recent years tend to restrain substantial inflationary pressures. But one cannot rule out the hypothesis that estimates made by the policy makers themselves also reflect their expectations that if inflation rates were to leave the comfort zone, the Committee would take the
necessary measures to correct the unbalance. When the subject is unemployment, however, there seems to be no reluctance to project numbers well above what can normally be viewed as equilibrium rates.

Moreover, in more than one occasion, Ben Bernanke made clear that he had no sympathy for raising the “target” for the inflation rate, even on a temporary basis, as had been suggested by a number of economists, adding that there would be no support for such a movement among his colleagues at the FOMC. However, one can conceive of something hopefully capable of being helpful in speeding up the economic recovery (the major concern in recent times) and which does not involve adopting a higher target for inflation. This has to do with admitting the possibility that, for a while, the rate of price growth may reach levels higher than the famous 2.0%. This is equivalent to saying that the just-mentioned “target” should not be viewed as a ceiling, which is clearly different from formally adopting a higher target.

Within the FOMC, voices in this direction started to appear in the second half of 2011. In fact, in a speech made in September of that year, Charles Evans, president of the Federal Reserve Bank of Chicago, stated that he did not think “a temporary period of inflation above 2.0% [was] something to regard with horror”, adding that he did not see “our 2.0% goal as a cap on inflation”. (Evans 2011, p. 5).

This line of reasoning was supported by vice chairman Janet Yellen, who would later put it this way: “reducing the deviation of one variable from its objective must at times involve allowing the other variable to move away from its objective. In particular, reducing inflation may sometimes require a monetary tightening that will lead to a temporary rise in unemployment. And a policy that reduces unemployment may, at times, result in inflation that could temporarily rise above its target”. (Yellen 2012, pp. 13-14). The message was clear: the Committee’s long term inflation goal (2.0%) should not be viewed as a ceiling for inflation.

Evans, Yellen and others (Kocherlakota, for example, from the Minneapolis Fed, who had also taken part in the debate) maintained this discussion with one specific objective in mind: changing the policy and the essence of the Fed’s communications
with the public, in particular as regards the directives given as to the future of the policy rate.

The zero lower bound (that is, a band between zero and 25 basis point) was reached in mid-December 2008. In announcing what would end up being the latest change in the policy rate, the Fed decided to indicate that future movements in the fed funds rate would only happen in a somewhat distant point in time. The idea was that, by signaling that it would take a long time for the policy rate to be raised again, the central bank would encourage consumers to spend and business to invest.

Forward guidance of this type is part of a central bank’s toolkit, being particularly attractive when the zero bound is reached, though it had already been used under different circumstances. In fact, in the US, Alan Greenspan resorted to such an instrument, in August 2003, when the policy rate had been pushed down to 1.0%. At that time, the signaling took the following form: “the Committee believes that policy accommodation can be maintained for a considerable period”. In January 2004, the wording changed into “with inflation quite low and resource use slack, the Committee believes that it can be patient in removing its policy accommodation”.

More recently, when the strategy was resumed, the wording was: “the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time” (press release of the FOMC meeting held on December 16, 2008). On March 18 of the following year, the final part of the sentence changed into “for an extended period”. In this second phase, the style was basically the same adopted previously, during the Greenspan era.

With the passage of time, however, the Fed decided to be more specific as regards what the policy makers meant by an extended period. In August 2011, the forward guidance incorporated a calendar date. The wording became: “economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013”. This was later altered to “at least through late 2014” (January 2012) and to “at least through mid-2015” (September 2012).

Evans and Yellen were uncomfortable with this approach because they felt that the message was not sufficiently clear. In Yellen’s words, “the Committee might
eliminate the calendar date entirely and replace it with guidance on the economic conditions that would need to prevail before liftoff of the federal funds rate might be judged appropriate”. She added that this would “enable the public to immediately adjust its expectations concerning the timing of liftoff in response to new information affecting the economic outlook. This market response would serve as a kind of automatic stabilizer for the economy: Information suggesting a weaker outlook would automatically induce market participants to push out the anticipated date of tightening and vice versa”. (Yellen 2012, p. 22). Yellen was endorsing a proposal previously made by Evans.

In September 2011, Charles Evans, president of the Federal Reserve Bank of Chicago, suggested the specification of numerical thresholds to describe the conditions that would warrant raising rates. The suggestion became known as the 7/3 proposal. In the proponent’s own words, “one way to provide more accommodation [when the zero bound had already been reached] would be to make a simple conditional statement of policy accommodation relative to our dual mandate responsibilities. […] This conditionality could be conveyed by stating that we would hold the federal funds rate at extraordinarily low levels until the unemployment rate falls substantially, say from its current level of 9.1% to 7.5% or even 7.0%, as long as medium-term inflation stayed below 3.0%”. (Evans 2011, p. 10). One year later, Narayana Kocherlakota, president of the Minneapolis Fed, made a similar proposal, with different thresholds, namely 2 ¼ percent for inflation and 5.5 percent for unemployment. (Kocherlakota 2012, p. 4).

In November 2012, Evans modified his own proposal. “I am ready to say that 6.5% looks like a better unemployment marker than the 7.0% rate I had called for earlier”. As to inflation, he realized that “the 3.0% threshold makes many people anxious”, this being the reason he modified the proposal to include a “modest number like 2.5%”, the reference being the total PCE index. (Evans 2012, p. 8).

It seems, then, that the FOMC was maturing the idea of allowing inflation to run at rates that would make members of the Committee uncomfortable in normal times. An attitude in this direction would be equivalent to giving more weight to the unemployment variable than had been the case until then.
It seems fair to say that, in the academic world, the most distinguished opponent of the language (or policy) originally adopted by the Fed was Michael Woodford. His criticism became widely noticed as a result of the paper he presented at the Jackson Hole Symposium, in late August 2012. At that occasion, the argument was put forward as explained below.

In essence, changes in the policy rate affect the economy through the impact they might have on the rates expected to prevail in the future. In other words, it is the future path of the policy rate that really matters. Monetary policy becomes more efficient if the authorities manage to generate expectations in line with the policy-rate path that is judged to be compatible with achieving the established objective.

Woodford emphasizes that market participants need to understand the authorities’ reaction function. In his words, “information about policy intentions is likely to affect the expectations of market participants more than information about the central bank’s view of the economic outlook, because the way in which the bank intends to conduct policy is a matter about which the bank obviously knows more than do outsiders” (Woodford 2012, p. 33).

Given the fact that it is the anticipated path of the policy rate that really matters for the economic decisions of consumers and firms, and as long as the authorities are confident that they are capable of effectively influencing the expectations regarding the mentioned path, there seems to be no reason for not trying to exert that influence by means of the so-called forward guidance mechanism. The point stressed by Woodford is that the ideal type of signaling should involve a sort of communication in which the policy makers state, as clearly as possible, what they intend to do, rather than giving the impression that they are simply engaged into forecast exercises. After all, market participants can always rely more on their own estimates than on the ones produced by the central bank.

If we examine carefully the language adopted by the Fed until the mid of last year, we cannot avoid the conclusion that the signaling lacked the necessary precision. In fact, what is really conveyed when the central bank says that the economic conditions are likely to warrant exceptionally low levels of the policy rate until a certain date? Should the statement be interpreted as a commitment, or as a simple projection? It is
quite hard to tell. What if the conditions change, and the economy’s recovery somehow speeds up? Will the policy rate be raised, prior to the specified date?

Woodford’s paper rapidly became required reading for specialists in the field, particularly because it seems to have influenced the Fed’s policy from that point onward. In fact, the first FOMC meeting after the Jackson Hole seminar was held on September 13 (date of the end-of-meeting statement). At that opportunity, the Committee decided to create a new open-ended program of additional purchases of agency mortgage-backed securities and opted for an important change in language. First, the new program is to be maintained until the conditions in the labor market show substantial improvement. Second, “the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengths”. For the first time, future changes in the course of monetary policy were being tied to economic outcomes (though vaguely defined), leaving behind the previous policy of announcing fixed amounts of purchases of certain securities over predetermined time spans.

On December 12, the change was more radical. The idea of thresholds originally suggested by Charles Evans (adjusted for his own new numbers) was formally implemented. In the end-of-meeting statement, one reads: “the Committee […] anticipates that this exceptionally low range for the federal funds rate [between zero and ¼ percent] will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and the longer-term inflation expectations continue to be well anchored”.

The NGDP Targeting Proposal

The criterion of thresholds was favorably praised by Michael Woodford prior to its implementation. “Adoption of such a commitment by the FOMC would be an important improvement upon current communication”, he said at the Jackson Hole Symposium. (Woodford 2012, p. 43). But Woodford’s real preference was for
something more drastic, involving a regime change, in which case there would be a commitment on the part of the Fed to pursue a nominal GDP target path.

In the central banking world, a similar way of thinking was recently expressed by Mark Carney, presently governor of the Central Bank of Canada and the governor-designate of the Bank of England. As is widely known, these two countries are early adopters of the inflation targeting regime. According to his view, successful practitioners of this regime may lead market participants to believe that inflation would not be allowed to remain above target, and those beliefs may reduce the effectiveness of monetary stimuli, at the cost of delaying economic recovery. Numerical thresholds somehow tie the hands of the central bank, making policy more effective. But Carney claims that this idea exhausts the options available within the current framework. In his opinion, “adopting a nominal GDP-level target could in many respects be more powerful than employing thresholds under flexible inflation targeting”. (Carney 2012, p. 8).

Before getting into some detail as to how a nominal GDP targeting strategy would work, let us add that in October 2011 the idea had been publicly defended by Christina Romer, who headed the Council of Economic Advisers during the first 20 months of the Obama administration. In an article published by The New York Times, under the title “Dear Ben: It’s Time for Your Volcker Moment”, Romer noticed that, as Fed chairman, Paul Volcker had “dramatically changed how monetary policy was conducted”. Bernanke should do something similar, that is, he should “stage a quiet revolution of his own”. (Romer 2011).

In the late 1970s, the strategy adopted by the Fed was not working, and the main problem of that time (inflation) remained without a solution. Today, the argument continues, inflation is low, but “unemployment is stuck at a painfully high level”. As in 1979, “the methods the Fed has used so far are not solving the problem”. (Romer 2011). We need, then, a new policy regime.

But how would the proposal work? The potential growth rate of the American economy is generally considered to be around 2.5% per annum. And since the Fed understands that the famous 2.0% is the long-term desired rate of inflation, the target for nominal GDP growth could be reasonably set at 4.5% per year. In order to define
the path we need a starting point, capable of being viewed as a “normal” year. In the graph below, we took 2007 as a reference year. The trend is built by extrapolating forward the nominal GDP observed in that year, at a rate of 4.5% per annum. The same graph shows the observed path of NGDP until 2012 as well as the extrapolation of the historical tendency (since 1990) into the future. As one can see, the American economy operates nowadays at a level which is 10.0% below the trend, as defined above. If the comparison is made with the historical NGDP trend (growth rate estimated around 5.3%), the divergence goes up to 15.0%.

Adopting the proposal would mean that the FOMC members would be committed to eliminating the gap. Since the Fed does not have enough control of the economy’s behavior, it would be advisable not to specify in advance the time span over which the gap will be closed.

In Romer’s mind, adopting the mentioned target would be equivalent to the decision taken by Volcker back in 1979, when he announced that the Fed would be targeting the rate of growth of the money supply, defined in a particular way. Supposedly, the main result would also be similar, that is, a considerable improvement in confidence. To the extent that this happened, consumers and firms would increase their spending. The economy would grow faster and the inflation rate might reach higher levels. In this case, a higher inflation rate would be considered helpful, and not a source of concern.
Announcement of the change in the monetary regime would be helpful per se. At least, so goes the argument. But it would surely not be enough to lead the economy to the desired track. This means that the announcement would have to be followed by further monetary actions. In reality, the Fed would need to be prepared to provide additional monetary stimuli, without specifying any limit for that. The so-called quantitative easing would enter into another phase. Still according to the proposal, there would be no reason to worries, since there would be a sort of an exit strategy embodied into the whole program. More specifically, the additional purchases of securities would be interrupted (and the policy rate would be taken to its neutral level) when the target were reached.

A final point needs to be made. How would the central bank evaluate the need for additional monetary actions? The idea here is simple and was already discussed in an old paper on the subject, written by Robert Hall and Gregory Mankiw. As these authors said in the early 1990s, the problem of lags in monetary policy is particularly relevant if a central bank adopts NGDP targeting. In their own words, it takes several months for monetary policy actions to affect the economy, “but the consensus forecast that far in the future is quite responsive to current monetary policy. Within a few days of a change in monetary policy, the consensus forecast changes to reflect expert opinions about the effects on all macro variables, including nominal income”. (Hall and Mankiw 1994, p. 78). The solution, then, is to work with forecasts, an idea which would later become a crucial aspect of the modern inflation targeting regime. In fact, in this case, the central banks usually guide their actions by the behavior of the inflationary expectations. As the Swedish economist Lars Svensson once said, “inflation targeting implies inflation forecast targeting: the central bank’s inflation forecast becomes an intermediate target”. (Svensson 1996, p. 2).

**Obstacles to Implementation**

It is difficult to predict whether the nominal GDP targeting proposal will ever be adopted. The fact is that the idea has been around for more than two decades and so far no one has effectively moved towards its implementation. Would the reason be the
fact that the target in this case is harder to be understood by the public than in the case of inflation targeting? Or would it be because conceptually it is generally considered not to be a good strategy?

It may be exact to say that the chances of adopting NGDP targeting are greater now than in the past because the reality is different. More specifically, central banks around the world have made use of a very large set of instruments (conventional and non-conventional ones) with the objective of promoting a rapid economic recovery. Generally speaking, the results have been quite positive, but the truth of the matter is that, so far, a large number of developed economies have not fully recovered from the recent crisis. In addition, the monetary policy strategy that prevailed prior to the crisis has been questioned in several circles. To some extent, it is no surprise that we find people suggesting a regime change, that is, something a bit more radical than what has been tried so far, with the objective of obtaining a more substantial improvement in confidence.

From the middle of this year onward, the Bank of England will be run by someone very sympathetic to the NGDP targeting proposal. Whether Mark Carney’s idea will be accepted or not is hard to tell. It very much depends on the Chancellor of the Exchequer. Although a movement in that direction is not presently expected, it is worth noting that surprises happen. In the 1990s, for example, the incumbent chancellor took two surprising measures. Norman Lamont, first, and Gordon Brown, second. Lamont established a target range for the inflation rate (1%-4%) one month after England abandoned her fixed exchange-rate policy. And, five years later, Brown set the Bank of England free to manage the country’s interest rate policy.

In the United States, those who defend the new proposal applaud the numerical thresholds policy, already in place. It is possible, then, to look at this latest movement as a preliminary step towards the adoption of the NGDP suggestion. But things are more complicated than that. In the US, the monetary policy’s objectives are determined by Congress. And the Fed does not seem to be in a comfortable position to attempt a more radical change. It must be recalled that the much simpler idea of inflation targeting never turned into reality, in spite of the fact that it had a much
larger support basis and benefitted from the experience of a quite substantial number of countries.

Besides this, it is not so clear that establishing a target path for nominal GDP is really a good idea. According to the proposal, any combination of inflation and real GDP growth is satisfactory, provided that the final result represents a movement towards closing the gap. If one establishes 4.5% rate of growth per annum for nominal GDP as the desired path, for example, a combination of 4.0% inflation rate and 1.5% real growth would supposedly do it, since this would contribute to diminish the distance to the stipulated path. But the question is: how long would such a scenario prevail? No one can really tell. Inflationary expectations, however, might be hurt, and the price system might lose an important anchor, a reasoning which, to begin with, rules out a large number of countries as potential candidates for the adoption of the NGDP targeting proposal. Economies with a long tradition of high inflation and where inflationary expectations are not well anchored should not even think about that possibility.

Another consideration has to do with the emphasis on economic growth. It took a couple of decades for academics, central bankers and economic analysts in general to understand and accept the fact that there are well-defined limits to what monetary policy can achieve. In the long run, central banks can only affect nominal variables, this being the reason why they should have their attention and efforts geared to the promotion of price stability. Tying their hands and forcing them to pursue economic growth seems quite dangerous, a movement which could put at risk a great deal of the progress so far obtained, particularly as regards the way monetary policy strategies should be conceived.

As is well known, monetary expansion and lower interest rates are demand-management instruments. Depending on the circumstances, aggregate demand may not fully respond to actions taken by policy makers. Marriner Eccles, a former chairman of the board of the Fed (1936-48), was the first to compare monetary policy to a string: while you can pull it to put an end to inflation, you cannot push it to take an economy out of a recession. According to Allan Meltzer, in a testimony before the House Committee on Banking and Currency, in 1935, Eccles’ words were; “you
“cannot push on a string”. Apparently, he had in mind a situation later to be known as liquidity trap. (Apud Meltzer 2003, p. 478).

It seems clear that monetary policy did not become totally ineffective, in recent years, as a radical interpretation of this reasoning would imply. In many countries, the economic situation would have gotten a lot worse were it not for the bold measures taken by government authorities, in general, but particularly by the central bankers. But the idea that central banks have been pushing on a string comes to mind when one recalls the enormous amount of monetary stimulus already given, in several countries, and the reluctance of consumers to spend, of banks to lend and of firms to invest. The circumstances, characterized by a long and costly process of deleveraging, made monetary policy much less powerful than in more normal times. Of course, things become even more complicated when a given economy faces severe supply-side bottlenecks, or sees her potential growth rate decline considerably. Monetary policy is unable to provide any sort of compensation for such factors.

As long as problems like these remain relevant, adopting the NGDP targeting proposal might be quite a risky strategy. A point may be reached, for example, in which an enormous amount of stimulus has already been given, with no adequate response on the part of the economy. In other words, forecasts for real GDP and for inflation might show rates of growth of nominal GDP below the established path. According to the new “rules of the game”, the central bank would be led to increase purchases of securities, bringing a great deal of discomfort to many people, probably within the central bank in question as well. Inflation expectations may suffer some damage, even in countries in which the monetary authorities have high credibility. In this case, nominal interest rates would incorporate these higher expectations, eliminating (partially or totally) whatever “gains” might have occurred in terms of the lowering of the real interest rates.

But even if inflationary expectations and inflation itself do not go up, and assuming economic growth does not accelerate, the distance to the target might increase, causing the central bank to lose whatever credibility it might have acquired, and perhaps forcing the discontinuation of the program.
In summary, it is not clear that nominal GDP targeting is really a good idea. Based on the reasoning here presented, we do not expect it to be adopted, at least in any reasonable scale. It may become the preferable strategy in one country or another, but it is not likely to get as widespread as the inflation targeting regime did.

J.J.S
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