Some problems with nominal GDP targeting

Being fashionable doesn't make it less wrong

Back in October I wrote a comment asking if central banks were moving away from their inflation targets. That was occasioned by a comment from Sir Mervyn King, but also by the Fed shifting towards unemployment targeting. Since then the Fed's shift has become more explicit, with interest rates now on hold until unemployment drops below 6½% (subject to some other conditions as well). Meanwhile, the incoming Governor of the Bank of England, Mr Mark Carney, has injected new life into the debate on nominal GDP targeting in Britain. (Significantly, *not* in Canada.) This idea has always had some supporters in the UK. Now it seems that the Chancellor has joined them, with editorials in a number of newspapers in support. Proponents of nominal GDP targeting in other countries are also popping up.

On the face of it, nominal GDP targeting is a beguiling idea. You target, eg, 5% growth in nominal income. If real income growth is too slow, you boost inflation to reach the target; if inflation is too high, you squeeze real growth to bring it down; or any combination thereof.

Nevertheless, this idea suffers from a number of flaws. First and most importantly, it assumes that you can indeed fine-tune an economy to the relevant extent by using monetary policy. That is highly unlikely.

However, this argument could be raised against any target. Is it possible to fine-tune an economy so that we achieve the inflation target we want two years (or so) down the line? Yes, under normal circumstances – but not necessarily in a crisis.

However, inflation targeting, with its flaws, at least has the advantage of simplicity. The concept of inflation is relatively easy to explain and to understand; the data is published monthly, with a lag of about three weeks in most countries; it is rarely revised; and it is easy to see whether the target has been hit or not. The policy instrument – the policy interest rate and how it affects the growth of broad money and hence activity – is also fairly straightforward. Finally the actions of the monetary authorities tend to have an immediate and noticeable effect on both households and companies.

By contrast, targeting nominal GDP is riddled with problems. There is the fact that GDP is a flawed measure at best. Then there is the decomposition of nominal GDP into real GDP and inflation, meaning that instead of one variable – consumer prices – we now have two – prices and activity. For the proponents of nominal GDP targeting, that is one of the advantages – if one of the components is 'misbehaving', you can adjust the other. For an outside observer, it seems to add to the complexity and hence make decision-making even more difficult. (Incidentally, is nominal GDP-targeting just a way of targeting real GDP growth? If so, why not say so; and it still won't work. If governments and central banks could command a particular growth rate, why haven't they done so already?)

There is also the fact that GDP is reported with substantial lags and subject to large revisions. Here, practice varies from country to country. In Australia and Sweden, eg, GDP is reported with slightly more

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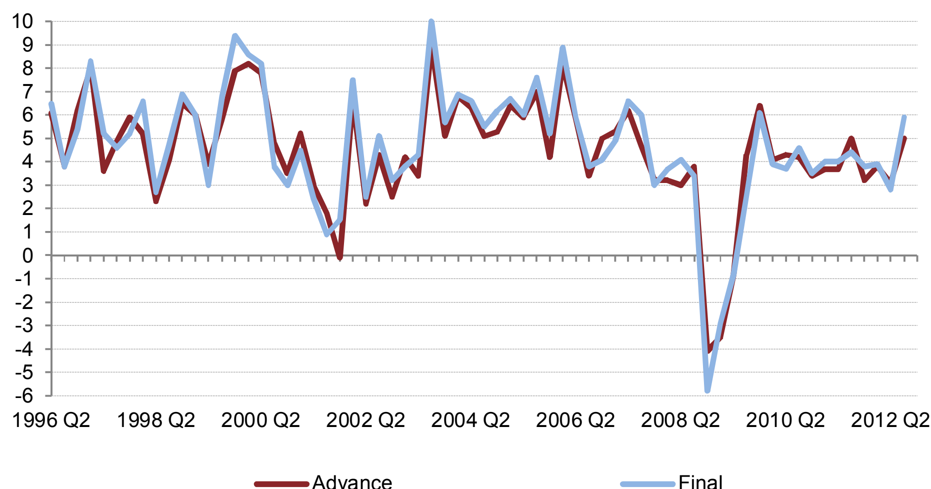
than a two-month lag. However, revisions are rare, usually taking place after multi-year intervals. For the euro area, there is a flash indicator six weeks after the end of the quarter, with a revised number published three weeks later. But there are also minute changes published with each series, often going back twenty years or so. Canada actually publishes monthly GDP data. Finally, for the United States and the United Kingdom, initial GDP data is published about one month after the end of the quarter, but that number is then revised twice over the next two months. The US also revises the last few years of GDP every year; and has a major ('comprehensive') revision every five years or so.

Using a target for monetary policy which at best is 9-10 weeks and at worst 12 weeks – one quarter of the year – out of date, does not seem the best way forward. The need for timely information means that GDP would have to be reported more frequently; but this runs up against the need for more accurate information. (The following calculations use US data because it happens to be the easiest available.)

Going back to 1996 (the extent of the archived releases published by the Bureau of Economic Analysis), the first ('advance') estimate of quarterly nominal GDP growth has averaged 4.5% at a seasonally adjusted annualised rate. The third ('final') estimate has averaged 4.7%.



As it happens, the very latest estimate (following all annual and comprehensive revisions since 1996) of average nominal quarterly GDP growth is 4.4%, so not too far off the original estimate. But this hides substantial revisions of the quarterly estimates. The maximum upward revision on record was for Q2 1997, where the advance estimate of nominal GDP growth was 3.7%; three years later this was revised to 7.9%. The largest downward revision was Q3 2008, where the advance figure showed a *rise* of 3.8% nominal GDP, eventually revised to a *fall* of 0.6%.

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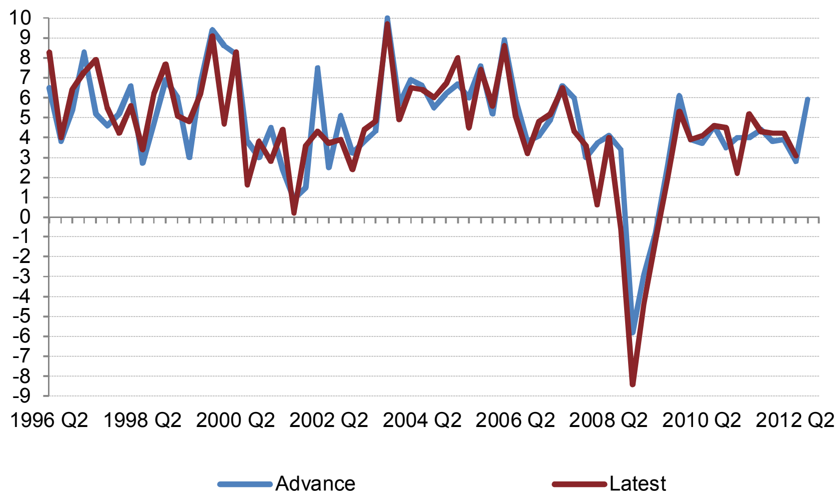
'Advance' and most recent estimates of US nominal GDP, quarterly change at seasonally adjusted annualised rate, %



Assuming that monetary authorities had targeted nominal GDP growth; and assuming further a growth target of 5%, with a certain amount of leeway – eg, ±1% – it is clear that the key signal would on both occasions have been massively wrong. Nor are these the only occasions when subsequent revisions have shown even the 'final' estimate of nominal GDP growth to be substantially out of kilter.

Of course, the object of monetary policy is not to target the latest number, but to aim for a number some time – usually about two years – down the line. However, even with inflation targeting, in spite of central banks valiantly publishing future paths of inflation, the focus inevitably ends up on the latest number, even though all it does is to tell us what happened over the twelve months to last month, not what will happen over the next 24 months. A mere look at the range of forecasts for any GDP release shows how difficult it is to get near an accurate forecast even at a time when we ostensibly know everything that happened in the relevant quarter. Trying to project growth two or more years in advance with any attempt at exactitude is almost certainly going to fail.

Of course, that something is difficult to do does not mean that it should not be attempted. But the main arguments against nominal GDP targeting do include substituting one target for two; the substantial uncertainty surrounding the two components of the target; and the impact of other influences. The latter was highlighted by Jeffrey Lacker, President of the Federal Reserve Bank of Richmond put it well in a speech on 4th January this year, when he said, "In contrast to inflation, real economic growth and labor market conditions are affected by a wide range of factors outside a central bank's control. In fact, the effects of monetary stimulus on real output and employment are less than is widely thought; they consist largely of the transitory by-products of frictions that delay the timely adjustment of prices by businesses.

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Attempts to overstimulate real economic activity via monetary policy can instead run the risk of raising inflation."

Perhaps more to the point, inflation targeting, with its flaws and problems, did and does actually work reasonably well. Not least, perhaps, because it implies the recognition that central banks (and governments) cannot create output growth; all they can do is to create an environment conducive to output growth, eg, by providing stable prices. By contrast, nominal GDP targeting is an attempt to do the impossible, ie create growth. It is therefore likely to be inherently more inflationary. And if we assume that the role of a central bank now includes financial stability, let it be noted that there is no reason why nominal GDP targeting would be more conducive to financial stability that inflation targeting. What it will do, however, is that policy almost certainly will become backward-looking, which is likely to lead to less stability, rather than more – financial or otherwise.

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