

## CAMRI Global Perspectives

Monthly digest of market research & views

Issue 36, September 2016

# Is it Time for A New Monetary Policy Target?

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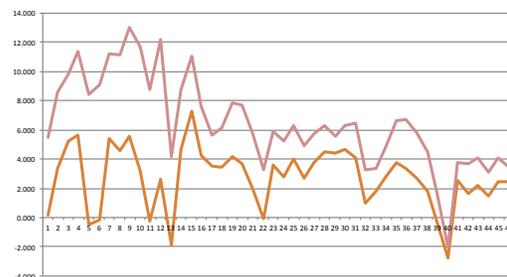
### Something is wrong with macro policy

Frustration throughout the developed world over a sluggish recovery from the great recession, and a gathering awareness that the proponents of secular stagnation may well be right, has led to demands for unrealistic and economically ineffective solutions. Politicians in many developed economies, particularly in the US, are championing unproductive economic ideas to placate the unrest among the great unwashed, knowing that retreat into nationalism and trade restrictions is a lose-lose economic proposition.

Perhaps it is time to challenge conventional wisdom regarding macro policy. The economic conservative policy advocates that have dominated mainstream macro policy for the past several decades need to surrender their hold on policy makers. Conservative policies such as budget discipline have not helped the Euro area, and years of the retreating budget deficits in the US have contributed to the slack and

politically unacceptable growth rates of the post 'great recession' era. More government spending on infrastructure would certainly help boost economic growth, and financing investment in the capital markets at historically cheap interest rates would not tax the national Treasuries very much.

Comparison of Nominal and Real GDP (annual % change)



It isn't only neglected fiscal policy that needs to change, but monetary policy also needs to be tweaked. Recently there has been a torrent of papers critical of recent monetary policy and suggestive of new policy targets. Apparently the fascination with inflation targeting has diminished amid the

disappointment with moderate to inadequate growth of the past 7 years.

**The new proposed target is nominal GDP**

According to a popular song from years ago ‘everything old is new again’ and that applies to the proposed new target: NGDP. In fact, NGDP targeting harkens back to the time when the equation of exchange was widely discussed within monetary circles. That old chestnut equated NGDP growth to monetary growth multiplied by velocity. Hopefully, today’s champions of NGDP targeting are not proposing to resurrect growth in the money supply as a tool to achieve desired NGDP growth.

NGDP targeting was seriously proposed by JE Meade in 1978 and a two years later in the US by James Tobin, both are Noble Laureates<sup>1</sup>. They both recognized a need to alter the then present monetary policy regime.

**Too much emphasis on inflation**

The present discussion of NGDP targeting implies that monetary policy makers focused too much on inflation targeting and not enough on real economic growth. Consequently, in policy makers’ endeavors to keep inflation at bay, they accepted too low a rate of growth in NGDP. Over the past six full years since the ‘great recession’ NGDP growth averaged 3.7% per year, a growth rate well below the post WW11 average of 6.5%, and even below the 6% average annual growth since 1983, the era following the

destruction of serious inflation and before the ‘great recession’.



**NGDP growth is too low**

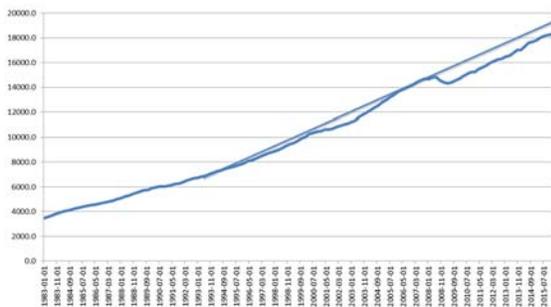
Selecting a different target still leaves open the question of determining the appropriate policy rate. For most of the past 33 years, the effective Fed funds rate shadowed the growth in NGDP. However, since the end of the last recession, the effective Fed funds rate has been at or near zero. Moreover, the real policy rate in many developed economies has been negative for most of that period. Nonetheless, negative real interest rates have not stimulated enhanced borrowing, or induced significantly more capital investment. This has raised serious questions over the effectiveness of current monetary policy to deliver its inflation and growth objectives. Virtually all-economic savants agree that NGDP growth averaging 3.7% is too low.

**Choosing a target rate of growth for NGDP**

Looking back over recent economic history in the US, NGDP grew slightly faster than 5% per annum during the period known as the

great moderation. If the Federal Reserve in today’s economic environment applied a NGDP growth target credibly, it would allow for a significant rise in inflation above the conventionally accepted 2% rate. Central bankers would then have to convenience market participants that this would be acceptable, and then supply sufficient funds to drive up the price level.

### NGDP is below its long-term trend



### An alternative target: the level of NGDP

The critical difference between a level and a growth rate target for NGDP is that past errors, or undershoots from a desired target level, would have to be made up in subsequent periods. Consequently, monetary policy would be kept ‘loose for longer’ and market participants’ expectations would be guided accordingly. A glance at Chart 3 reveals that the present level of NGDP is approximately 12% below the level implied by the long-term trend that existed before the ‘great recession’. Consequently, if a level of NGDP target guided policy, it would imply that monetary policy would have to stay loose for well into

the future for NGDP to catch up to its long-term trend.



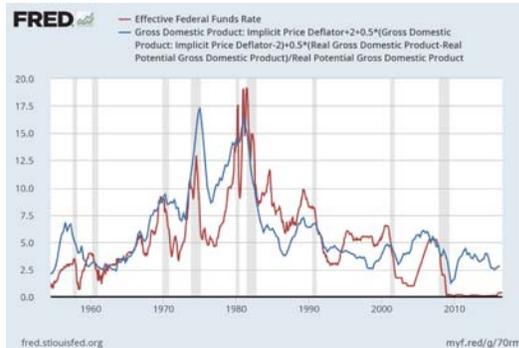
### Another look at the Taylor Rule

John Taylor, professor and former Federal Reserve governor, constructed a policy rule for the effective Fed funds rate for monetary policy makers to use when they are subject to two targets: containing inflation and promoting full employment. His rule works well for NGDP since it addresses both components of NDGP: the GDP deflator and real economic growth.



The Taylor rule, as calculated by the Federal Reserve Bank of St. Louis, is now, and has been since the end of the last recession, several hundred basis points above the actual effective fed funds rate. In contrast, in

the decades before the last recession, the difference between the effective fed funds rate and the rate implied by the Taylor rule was significantly less: at around 70 basis points.



### A Lower natural real rate

In the FRB of St Louis’s version of the Taylor rule the real fed funds rate, or the short-term natural real rate of interest, is assumed to be 2%. However, in the post financial crisis world, many prominent economists have argued persuasively that the real short-term interest rate has plummeted to less than 1% across most of the developed economies, and some believe it is near zero<sup>2</sup> in the US. This natural real rate is estimated when the economy is at full employment. Consequently, the Taylor rule adjusted for a significantly lower real rate would halve the gap between it’s proposed rate and the present fed funds rate.

### The problem with a low real rate

There are a host of reasons theorized about the onset of secular stagnation that have contributed to the decline in the real rate

throughout the developed world. The most compelling argument explaining the decline in the natural rate over the past several years is that the supply of funds has exceeded the demand for funds. Excess capital created in rapidly growing emerging economies has poured into safe harbors in the developed world, and the developed world has seen public and private capital investment shrink in the post financial crisis era. This is one of the most observable results from secular stagnation.

As a result of ever changing demographics, slower productivity growth, and a glut of savings that are unlikely to disappear soon, it strongly implies that real rates will be lower for the foreseeable future. This implication poses a great challenge for future monetary policy because such a low natural rate of interest will restrict the use of a key tool of monetary policy: to significantly lower interest rates during an economic downturn. Historically, the Fed has reduced its fed funds rate by several hundred basis points during a cyclical episode of monetary stimulation. Now it won’t be able to.

### Back to NGDP targeting

Some economists have recommended that one technique to fix this vexing monetary problem is to target NGDP instead of inflation. The most simplistic argument advanced for a NGDP target is that if real growth diminishes, it will give latitude for inflation to rise in order to maintain the central bank’s NGDP growth target. That is,

if trend productivity growth declines, or for all the other reasons that were previously mentioned that lead to a low natural rate condition, then an automatic increase in targeted inflation would spontaneously lead to a higher nominal level of interest rates. And, this would yield a higher policy rate for the monetary authorities to use in order to stimulate more real growth. Of course market participants must believe that the monetary authorities will accept and even desire a higher inflation rate.

### **An Informed critique of NGDP targeting**

Throwing some light on the merits and demerits of NGDP targeting versus current policy approaches, Charlie Bean, former vice chairman of the monetary policy Committee of the UK, pointed out that many countries already are pursuing two mandates to some unspecified and inconsistent degree, as in the US and UK<sup>3</sup>. Therefore, he argues that the actual economic outcome from having an actual NGDP target versus the current practice wouldn't be very different. However, under a regime of NGDP targeting it would probably be easier to justify decisions taken by the policy makers than in the context of the vague dual mandate approach presently used.

In addition, another complaint about NGDP targeting is that the data is heavily revised from first report through many successive rounds of annual revisions. Consequently, it might be more difficult for any central bank

to prove their credibility and achievement under a NGDP target approach.

### **Conclusion: tweaking monetary policy is not a panacea**

Surely some new approach to monetary policy is appropriate after years of pursuing inflation targeting. Consider, the dissatisfaction with the insufficient stimulus that current policy has provided, and the obvious meager economic results. The evidence of inadequate economic growth is everywhere in the developed economies of the world and the frustration with present macro policies are palpable. If the current economic malaise is really due to secular stagnation in the developed economies, then tweaking monetary policy is not going to be an effective solution. The Bank of Japan has pursued zero based interest rates and enormous amounts of quantitative easing for nearly two decades, while the economy in Japan has endured years of disinflation and recession.

Instead, the developed economies need a big kick from aggressive fiscal policy. New infrastructure investment, greater incentives to apply new technologies, and fewer anti-productive regulations will help boost aggregate demand in developed economies faster than more quantitative easing and perpetually low interest rates.

Endnotes:

1 Meade, J.E. (1978). 'The meaning of internal balance.' *Economic Journal*, vol. 88, (September), pp. 423-35.

Tobin, J. (1980). 'Stabilization policy ten years after.' *Brookings Papers on Economic Activity*, vol. 11, pp.19-90.

2 Laubach, Thomas, and John C. Williams. 2015. 'Measuring the Natural Rate of Interest Redux.' FRB San Francisco Working Paper 2015-16, October, forthcoming in *Business Economics*.

3 Nominal income targets: an old wine in a new bottle Speech given by Charlie Bean, Deputy Governor for Monetary Policy, Bank of England, 27 February 2013

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KEY INDICATORS TABLE (AS OF 31 AUGUST 2016)								
INDEX	LEVEL (LC)	%1MO (LC)	%1MO (USD)	%1YR (LC)	%1YR (USD)	INDEX	LEVEL	%1YR
S&P500	2170.95	0.14%	0.14%	12.54%	12.54%	3MO LIBOR	0.84	155.12
FTSE	6781.51	1.67%	1.00%	13.00%	-3.50%	10YR UST	1.58	-28.76
NIKKEI	16887.40	1.99%	1.07%	-8.89%	6.96%	10YR BUND	-0.07	-108.10
HANG SENG	22976.88	5.23%	5.26%	10.39%	10.29%	10YR SPG	1.01	-51.96
STI	2820.59	-0.21%	-1.57%	0.35%	4.03%	10YR SGS	1.80	-36.65
EUR	1.12	-0.14%		-0.47%		US ISM	49.40	-3.14
YEN	103.43	1.34%		-14.68%		EU PMI	51.70	-1.15
CMCI	1038.45	-0.16%		1.88%		JP TANKAN	4.00	-42.86
Oil	44.70	7.45%		-9.15%		CHINA IP	6.00	-1.64

Source: Bloomberg

## APPENDIX

### GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US\$ where applicable)

**S&P500:** capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)

**FTSE:** capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)

**NIKKEI:** capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)

**HANG SENG:** capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)

**STI:** cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)

**EUR:** USD/EUR exchange rate: 1 EUR = xx USD (EUR)

**YEN:** YEN/USD exchange rate: 1 USD = xx YEN (JPY)

**CMCI:** Constant Maturity Commodity Index (CMCIPI)

**Oil:** West Texas Intermediate prices, \$ per barrel (CLK1)

**3MO LIBOR:** interbank lending rate for 3-month US dollar loans (US0003M)

**10YR UST:** 10-year US Treasury yield (IYC8 – Sovereigns)

**10YR BUND:** 10-year German government bond yield (IYC8 – Sovereigns)

**10YR SPG:** 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)

**10YR SGS:** 10-year Singapore government bond yield (IYC8 – Sovereigns)

**US ISM:** US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)

**EU PMI:** Purchasing Managers' index for the 17 country EU region (PMITMEZ)

**JP TANKAN:** Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)

**CHINA IP:** China's Industrial Production index, with 1-month lag (CHVAIOY)

**LC:** Local Currency

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