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Food for thought for monetary policy

by Michael Heise

Despite the deployment of negative interest rates and bond purchases many central banks are struggling to get inflation back up to the desired level of around 2%. As a result, a debate is raging across the globe about the direction of monetary policy. Many proposals should be shelved immediately – such as the call to finance government debt with the printing press (helicopter money) or the idea to double the inflation target from 2 to 4%. Such an act of desperation by the central bank would require yet more rash monetary action, damage its credibility and spawn even greater risks on the financial markets.

It would be better to define price stability as inflation between 0 and 2%. But this proposal – which I have presented here in this column before – seems to have fallen on stony ground at the ECB. So perhaps another path is worth considering: not to gear monetary policy rigidly to changes in consumer prices but to changes in nominal gross domestic product (GDP), which evaluates and tots up the overall output of an economy at current prices. The proposal is not new but has its advantages: Firstly, GDP is less susceptible to fluctuations than the consumer price index. This should help smooth out monetary policy operations. Secondly, nominal GDP is predominantly influenced by domestic inflation, which the central bank needs to aim at, and not so much by import price developments and commodity prices. Thirdly, focusing on nominal GDP is ultimately more simple and more accurate than targeting inflation directly. It is then irrelevant whether a monetary policy signal impacts the price level directly or real output.

How does the concept work? First of all we need to determine a benchmark for the long-term growth trend. In the eurozone this currently stands at 1.5- 2%. On top of this comes the rate of inflation deemed appropriate over the longer term, which is of a similar magnitude. So, overall, this gives a figure between 3 and 4%. If the economy grows at a pace below, on a par with or above this figure, this would signal to the central bank to pursue an expansionary, neutral or restrictive policy. In the first half of 2016 nominal growth in the eurozone was slightly below this range at 2.8%. So the ECB should pursue an expansionary course but there is nothing flagging up a crisis requiring extreme action.

Central banks are understandably reluctant to redefine their strategies in response to contemporary challenges. But the problems inherent in inflation targeting have been evident for a while now. It is time to rethink the strategy. The reputational damage suffered by a central bank that misses its targets for years on end is doubtless greater than that from a well-justified change in strategy.