RESEARCH SUMMARY

Assessing Monetary Policy in the Eurozone

All central bankers must address a key question: What is our current monetary policy stance? But unfortunately, there is little agreement over how to gauge that stance. In “A New Measure of the Stance of Eurozone Monetary Policy,” Patrick Horan and Samukai Sarnor make the case for using the “NGDP gap” as a valuable metric.

What Is the NGDP Gap?

In 2020, Mercatus scholar David Beckworth proposed the NGDP gap as a measure of the stance of monetary policy for the United States. The measure compares total spending for all the goods and services in the economy (nominal gross domestic product, NGDP) to what it was forecasted to be. If the measure is not close to zero, then there may well be turbulence ahead for the economy.

- A positive NGDP gap indicates that NGDP is higher than what the public expected it to be. Monetary policy is thus considered to be expansionary (too “loose”) and will cause inflation.
- A negative NGDP gap indicates that NGDP is lower than what the public expected it to be. Monetary policy is thus considered to be contractionary (too “tight”) and will cause the economy to stagnate.
- An NGDP gap of zero indicates that monetary policy is neutral, i.e., it is neither inflationary nor disinflationary.

What Does the NGDP Gap Show for the Eurozone?

Horan and Sarnor create a parallel NGDP gap for the Eurozone. For the Eurozone, the measure indicates the following:

a) Eurozone monetary policy was more contractionary than US monetary policy in the aftermath of the Great Recession.

b) More recently, the NGDP gap shows that Eurozone monetary policy has been excessively expansionary, albeit less so than in the United States.

A Metric That Can Help Assess Policy

The NGDP gap’s past performance and the fact that it is derived from directly observable data suggest that it could be of use to policymakers and economists. The measure offers them another way to determine whether current policy is on track.