



A MARKET-DRIVEN NOMINAL GDP TARGETING REGIME

In addition to destroying any illusions that the “Great Moderation” had ended debate over monetary policy, the Great Recession opened up a debate about the role and methods of central banks in the United States and around the world. Many have criticized the role of the Federal Reserve (Fed) in the crisis, but economists don’t even agree about whether the Fed’s monetary policy was too inflationary or too contractionary.

In a paper for the Mercatus Center at George Mason University, economist [Scott Sumner](#), director of the Mercatus Center’s Program on Monetary Policy, evaluates the Fed’s role in the Great Recession and makes the case for establishing a market-driven nominal GDP targeting regime. Sumner—one of the world’s foremost experts on nominal GDP targeting—examines how US monetary policy failed during the Great Recession, and how a nominal GDP futures targeting regime could prevent the next recession.

To read the paper in its entirety and learn more about its author, see “[A Market-Driven Nominal GDP Targeting Regime](#).”

WHAT IS MONETARY POLICY? AND DOES IT MATTER?

Monetary policy is not easily defined and leading economists emphasize different aspects of monetary policy. Some define it in terms of the *quantity* of money in the economy, others focus on the *price* of money, and still others see it in terms of changes in the *rental cost* of money.

However it is defined, most economists agree about what a successful monetary policy should look like:

- Monetary policy should promote stable economic growth and low inflation.
- It should also provide sufficient liquidity to keep the financial system stable.

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One of the strengths of nominal GDP targeting is that it sidesteps the question of what variables a central bank should target, and instead focuses directly on these ultimate macroeconomic policy goals.

WHAT WOULD A NOMINAL GDP FUTURES TARGETING REGIME LOOK LIKE?

Monetary policy could be greatly improved by a regime of “targeting the forecast,” or setting policy so that the expected growth in nominal GDP is equal to the central bank’s target growth rate. The central bank could accomplish this goal by setting up a nominal GDP futures market and then adjusting the monetary base to stabilize nominal GDP futures prices. The market, not the central bank, would set both the level of the monetary base and short-term interest rates under this sort of policy regime.

- For example, if the central bank’s goal were 5 percent nominal GDP growth, then it would adjust its policy instruments until the futures market also forecast 5 percent nominal GDP growth. In most cases, its policy instruments would be buying and selling government bonds on the open market.
- Eventually, the buying and selling of government bonds could even be automated, with every “long” or “short” purchase on the futures market triggering a corresponding open-market operation. For instance, each \$1 purchase of a long position in a nominal GDP futures contract might trigger a \$1,000 open-market sale by the Fed, while a \$1 purchase of a short position would trigger a \$1,000 open-market purchase by the Fed. Investors would effectively be determining the size of the monetary base.

CRITICISMS OF NOMINAL GDP FUTURES TARGETING

There are several common criticisms of nominal GDP targeting. All of them either stem from a misunderstanding of how nominal GDP targeting works or refer to problems that could be fixed by modest adjustments to the regime.

- **The circularity problem: What if nothing happens because the markets are watching the central bank for direction at the same time as the central bank is watching the markets for direction?** Placing all the decision-making power in the hands of the market essentially solves this problem. The market effectively predicts the optimal instrument setting as it implements policy. The nominal GDP futures price doesn’t change; rather, the monetary base changes as needed to keep futures prices stable.
- **The first-mover problem: Why would investors trade before the end of the period?** If periods are only once every three months, this could be problematic. By using monthly nominal GDP estimates provided by private firms such as Macroeconomic Advisers and then taking weighted averages, the Fed could construct daily nominal GDP estimates, which would mean a new period each day.

- **The problem of data revisions: What if there are revisions to nominal GDP?** The payoffs can be based on the first announcement, as long as the initial estimate is unbiased. Any longer-term revisions in the definition of GDP, such as adding the underground economy, should be addressed by adjusting the policy goal.
- **Concerns about market liquidity: What if no one trades?** If no one trades long or short options on a given day, that means the market believes the current monetary policy is on the correct trajectory to reach the target nominal GDP.
- **Bias resulting from hedging or risk aversion: What if the risk premium causes disruptions?** Any risk premium that forms will likely be very small. But even so, as long as the risk premium remains relatively steady, the macro instability should be minimal. It is only time-varying risk premiums that cause problems.

CONCLUSION

Adopting a regime of nominal GDP targeting based on futures markets would not only provide the best foundation for stable economic growth, it would also remove the justification for future government bailouts and stimulus spending. A fully automated system would remove all discretion from the Federal Reserve. US monetary policy needs a system of guardrails that will prevent the United States from falling into another demand-side recession, or period of high inflation. A nominal GDP targeting regime would provide such a system.