

MONETARY REGIME CHANGE

An old order fails

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TWICE in the last century, economic turmoil revealed the failure of a monetary regime and forced the West to abandon it for another. During the Great Depression of the 1930s one country after another abandoned the gold standard—a decision vindicated when they recovered in the same order. The inflation of the late 1960s and 1970s, meanwhile, persuaded most of the developed world’s central bankers to quit trying to “fine-tune” the real growth rate of the economy and instead concentrate on achieving price stability.

It is once again time for regime change. The crisis in Europe and our stagnation at home both have primarily monetary causes, and a solution will require a new approach to monetary policy that learns from both the successes and the failures of the past.

It’s all but universally accepted that the interwar gold standard made the Great Depression worse. When the French government hoarded gold, its value increased. So in countries that defined their currencies in terms of gold, all other prices, including wages, had to drop. Labor markets tend to react badly to such downward price pressure, resulting in high unemployment and reduced output. A vicious circle then sets in: The economic pain calls into question the government’s commitment to staying on the gold standard, which encourages gold hoarding, which in turn raises the value of gold further and thus makes the pain worse. Only an actual departure from the gold standard made it possible to exit the trap.

Central banks largely avoided deflation in the following decades. As time passed, however, they increasingly erred in the opposite direction, attempting to increase economic growth through monetary stimulus. The high inflation of the 1970s had two causes. The lesser cause was a set of negative supply shocks. Rising oil prices reduced Westerners’ standard of living and raised price levels generally: regrettable outcomes, but not ones that central banks can do anything sensible to prevent. The more important cause, however, was overly loose monetary policy.

After both of these episodes, policymakers in most developed countries drew the lesson that both high inflation and

deflation should be avoided. The typical approach central banks adopted was to manipulate interest rates in a way that would keep inflation at a low and stable level. Some nations even imposed the goal of low and stable inflation on their central banks by statute—although not the United States, which asks its Fed to seek both full employment and stable prices. But few countries adopted a rigid inflation target, preferring instead a “flexible” one that allowed central banks, for example, to risk a bit more inflation as they fought recessions.

For more than two decades flexible inflation targeting seemed to work pretty well, but its flaws have of late become more apparent. It can yield inappropriate responses to supply shocks because monetary authorities may fail to distinguish them from loose money. Thus the Federal Reserve at the height of the financial crisis in September 2008 refrained from cutting interest rates, and the European Central Bank in the midst of the euro-zone crisis in 2011 actually raised interest rates twice, in response to rising commodity prices.

Flexibility also means, in practice, unpredictability, undermining the crucial purpose of a sound monetary policy: making it easier for economic actors to make and coordinate their plans. For example, for people to make long-term plans, central banks should make up for undershooting the inflation target in one year by overshooting it in another, and vice versa. The goal should be to make the price level of ten years from now as predictable as possible. Perhaps because inflation is unpopular, however, central banks have been unwilling to raise their inflation targets to make up for the deflation and disinflation that have occurred over the past few years.

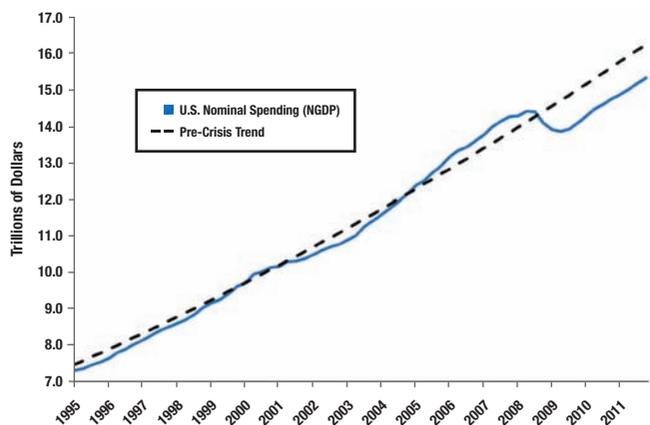
Making matters worse is that the gradual decline in the economy’s trend rate of growth, combined with the decline in inflation, made nominal interest rates very low, especially in recessions. Given that central banks have grown accustomed to running monetary policy by manipulating interest rates, this situation left them in a bind. Their instinctive response to a slump was to try to reduce interest rates—but they had no room to do so. Thus the ad hoc resort to unorthodox policies such as quantitative easing.

The Fed’s initial response to the recession that began in 2007 and deepened in 2008 was to tighten money. It did so actively by paying banks interest on reserves at a rate higher than they could get from alternative safe investments such as U.S. Treasury securities. The banks, therefore, were incentivized to hold money instead of investing it. The Fed passively tightened by failing to offset the sharp drop in the total number of dollars being spent in the economy. When this number—called nominal spending—drops, it is because the demand to hold money increases or the supply of money decreases. By mid-2008 both forces were at work. Households and firms were holding more money and spending less at the same time financial firms were creating fewer assets that serve as money. When the number of dollars spent falls, so of course must the number of dollars made (nominal income). Either prices have to fall, the real economy has to shrink, or both. We got some of both. The Fed has not done nearly enough since then to correct its mistake.

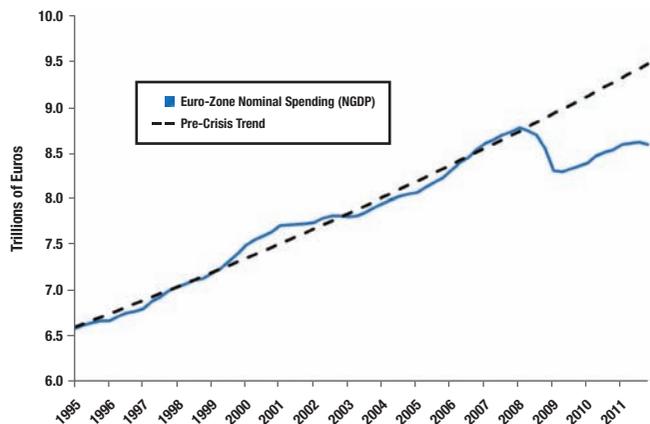
The Bank of England and the European Central Bank have also been much too tight. (The Bank of Japan has been too tight for a generation.) Americans, especially American con-

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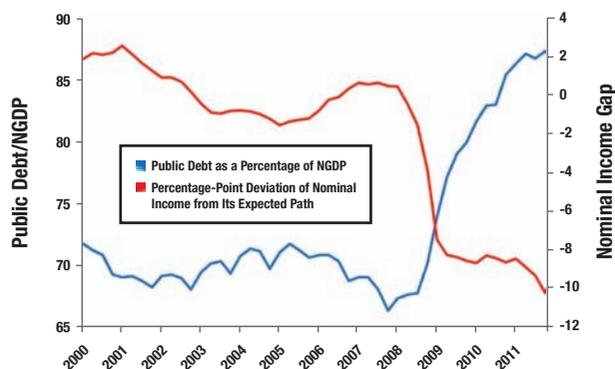
Monetary Policy Is Tight In the U.S.



Monetary Policy Is Tight In the Euro Zone



Euro-Zone Crisis Is a Nominal-Income Crisis



servatives, tend to think of Europe’s current crisis as the result of overspending welfare states. And these states would indeed be better off with lower spending levels and less regulated labor markets. But many of the nations swept up in the euro-zone crisis, such as Spain and France, had spending and tax revenues well aligned before it hit. The true problem has again been monetary. Europe has for a decade had a monetary policy well suited to the circumstances of Germany but not to those of the rest of the euro zone and especially its periphery. Nominal income in Germany has stayed on a fairly steady trend line. In the periphery, however, it first went way up and then crashed. For the euro zone as a whole, nominal spending has fallen far below its previous trend—and has been continuing to fall farther away from it. Monetary policy therefore remains very tight in the euro zone overall.

One effect of that drop-off, in Europe and in the U.S., has been to make debt burdens more onerous. Most American mortgages, for example, are made in nominal terms. For a generation before the crisis, those debt contracts were made against a background of stable growth of nominal income: Every year the economy, in dollar terms, grew about 5 percent. When nominal income abruptly fell off that trend, debt loads suddenly became much heavier than people had expected. (Contracting new debts also became much riskier.)

In Europe, the drop-off in nominal income compared with trend made for a sharp and simultaneous increase in the ratio of debt to nominal income. Yet the European Central Bank has been unwilling to let expected inflation rise above its 2 percent target, even to make up for the deflationary crash. “The credibility of the ECB,” its president, Mario Draghi, said recently, “is one of the few things left.” The remark was reminiscent of Herbert Hoover’s boast, during his 1932 reelection campaign, of having defended the dollar value of gold.

What we now have is an inappropriately tight monetary policy that afflicts much of the globe. It is by no means clear that the Federal Reserve will act to keep nominal spending on even its current, anemic trend if the euro-zone crisis sets off another velocity-reducing panic. Nor is it clear that the Fed will offset the effect of the automatic tax increases and spending cuts scheduled to take effect at the start of next year.

WHAT is needed, then, is a new monetary-policy regime that moves nominal spending back toward its pre-crisis trend and keeps its future growth stable.

Doing so would promote a faster recovery, prevent the Fed and the ECB from mistakenly responding to supply shocks, and firmly anchor long-run inflation expectations. A nominal-spending-level target is just such a regime.

Under this rule, central banks would be required to try to keep nominal spending growing at a certain rate and to correct for past failures to hit the target. In the United States, it would be reasonable to set that growth rate at 5 percent a year, in keeping with the pattern of the economically stable quarter century prior to the crisis. If the real economy grows by 3 percent a year on average, as it has done in recent decades, the rule would lead to an average inflation rate of 2 percent per year. As noted earlier, however, nominal spending is currently far below the pre-crisis trend. So the Fed would for some

time have to accommodate nominal-income growth above 5 percent annually to shrink the gap.

The Fed could do this by committing to buy up as many securities as needed to hit its target. Unlike previous large-scale asset purchases by the Fed, this would be a *conditional* purchase tied to an explicit target. It therefore would be more effective in guiding market expectations and, in turn, less costly for the Fed. If Fed chairman Ben Bernanke announced that the Fed was going to act to bring nominal spending back to the pre-crisis trend, it would send shock waves through the markets.

Portfolios would automatically adjust toward riskier assets in anticipation of the Fed action. This would create expectations of higher asset prices, as would expectations of higher nominal-income growth. As a result, the demand for money would fall and financial firms would start making more money assets. Current nominal spending would quickly respond to these developments, helping the Fed hit the target and thus reducing the need for the Fed to purchase more assets. The Fed's balance sheet, therefore, would not have to expand as rapidly as it has over the past few years. Australia provides a useful example of how markets do the heavy lifting under a sound monetary policy. It has kept nominal income rising—it has avoided recession for 20 years—but it

nominal income would instead simply keep total current-dollar spending stable and allow the supply shock to work itself out. In an important sense it would, as it should, take no notice of it.

Alternatively, imagine that a new technology significantly increased the speed of computers. This one-time productivity-enhancing supply shock might temporarily result in 5 percent real economic growth and 0 percent inflation under our rule. A 2 percent inflation target would again have a perverse consequence; this time it would require a potentially destabilizing surge in nominal spending to raise inflation. Better to ignore the supply shock and allow the temporary disinflation than to have a boom in spending.

A final virtue of the rule is that it would anchor long-run inflation expectations. If it were widely known that current-dollar spending would be kept on a stable long-run path, with corrections for short-term deviations, long-run inflation expectations should be stable as well. There is therefore no need to worry that moving closer to the pre-crisis trend of nominal spending would yield 1970s-type inflation.

THE West's previous monetary regimes succeeded to the extent they approximated a rule stabilizing the growth of nominal income and failed to the extent they did

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has a much smaller monetary base (compared with the size of its economy) than we do.

Two other benefits could be expected. First, the pickup in economic activity would increase the demand for credit by households and firms. This increased demand, in turn, would cause interest rates to rise, helping savers. (The fact that interest rates are currently so low is a testament to the failure of flexible inflation targeting to restore robust economic growth.) Second, a strong increase in nominal spending would eliminate any arguments for further fiscal stimulus. Moreover, it would allow for meaningful budget cuts without jeopardizing the economic recovery. To the extent spending cuts reduced nominal income, the central bank could act to keep it on trend. Indeed, market expectations that the trend would continue would do most of the work automatically. Fiscal austerity would become far easier to implement.

A nominal-spending-level target would also help central bankers avoid the temptation to respond to supply shocks. Consider, for example, a super virus that temporarily shut down many computer systems. Under the monetary-policy rule, this negative supply shock might temporarily result in 0 percent real economic growth and 5 percent inflation. Sticking with an inflation target of 2 percent would require a tightening of monetary policy that would further constrict an already weakened economy. A central bank that was targeting

not. The interwar gold standard contributed to a disastrous collapse of nominal income. The inflationist policies of the 1960s and 1970s made it grow at an unpredictably accelerating rate. For many years flexible inflation targeting came close to a nominal-income rule. Since today's crisis began, it has done better than the interwar gold standard—but not nearly well enough.

If central banks adopted an explicit rule for the growth of nominal income, with the proviso that they would correct for short-term departures from the target, they could pocket the gains we have made in monetary practice while fixing some serious remaining flaws. The difficulty of using interest rates as an instrument at the zero bound, the inability to restabilize long-term expectations after a deviation, and the inappropriate responses to supply shocks would all cease to be problems. The Fed's dual mandate would be obeyed, but its flexibility would be constrained by a rule and thus its behavior made predictable.

Adopting a nominal-income rule would not, of course, solve all the structural problems that beset modern economies. The reform of entitlements, tax codes, and labor laws would all remain pressing concerns in many countries, and failure to reform them would undermine long-term prospects for real growth. But monetary policy would do what only it can do to promote macroeconomic stability. Without that stability no set of reforms is likely to succeed, on either side of the Atlantic.

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