In 2012, we saw a growing consensus that the tenets of modern central banking are inadequate. After the inflationary 1970s, the big central banks moved towards inflation targeting. And for a quarter century this new policy regime seemed to work well, producing relatively stable growth and low inflation. But now it has become clear that something is wrong with the standard model.

Consider the debate over fiscal policy. Inflation targeting was supposed to make demand-side fiscal policy obsolete. After all, both monetary and fiscal policy affect the exact same variable – total nominal spending, or what economists call “aggregate demand”.

Once a central bank sets an inflation target, they have essentially set a path for aggregate demand. In that case, what possible role can there be for fiscal stimulus? But as the past few years have shown, stimulus advocates and opponents are as vociferous as ever. And despite a widespread perception that most developed economies would benefit from more demand, central bankers seem unwilling or unable to deliver that growth.

Inflation targeting failed in two ways. First, it was a poor indicator of the adequacy of aggregate demand. Second, it is susceptible to “liquidity traps”, a period of near zero interest rates where central banks’ favourite tool – interest rate targeting – is rendered ineffective.
In recent years, the Bank of England has been criticised for allowing above-target inflation at the same time that the David Cameron government is criticised for fiscal austerity. One of those criticisms might be correct (although I doubt it) but surely both cannot be right. Either Britain has too much demand or it does not. Most likely it has too little demand, and inflation, which is also affected by value added tax and import prices, is a poor indicator of demand.

Inflation targeting also failed because it targeted the growth rate of prices, not the level. When prices fell in the US in 2009, the Federal Reserve did not try to make up for that shortfall with above target inflation. Instead it followed a “let bygones be bygones” approach. This makes it hard to lower real interest rates at the zero rate bound, and more likely that economies will get stuck in a liquidity trap.

This problem occurs because when the economy is very weak, even a 2 per cent inflation target might not be high enough to generate the sort of bullish expectations needed to stimulate demand. There’s already plenty of money in the system – we need higher spending growth expectations to push that money into circulation.

This is not to say that the various quantitative programmes have not been helpful. They’ve boosted asset prices and prevented an even deeper slump. But they haven’t been sufficient to promote a rapid recovery. In the eurozone there is no recovery at all. It is clear that the world’s big central banks need to move to a new policy regime in 2013, one that targets the level of nominal spending, not the growth rate of prices.

Mark Carney’s speech on December 11 in Toronto demonstrated the growing interest in replacing inflation targeting with nominal gross domestic product level targeting, even among central bankers. The central bank would set a growth path for nominal GDP of perhaps 4 per cent or 5 per cent per year, and commit to return to that trend line when spending falls short or overshoots. Nominal GDP targeting would moderate the business cycle by being more contractionary than inflation targeting during a boom and more expansionary during a recession. And NGDP could do this while still delivering roughly the same long-run rate of inflation.

And there are many other advantages. If investors had known in 2008 that any declines in NGDP would be quickly made up, then asset prices would have fallen much less sharply, and demand
would also have been more stable. The current prices of stocks, commodities and property are strongly influenced by their expected prices several years out. The severe asset price decline of late 2008 reflected the belief that central banks would fail to take decisive action to restore NGDP to the trend line.

Some fear that inflation will become unanchored if we move to NGDP targeting. In fact, most of the problems that people associate with inflation are more closely linked to high and unstable NGDP growth. Wages tend to follow growth in national income. As long as NGDP growth is low and stable, wages and core inflation will remain well anchored.

A stable path for NGDP growth will also produce better policy decisions in other areas. Fiscal spending will have to be justified on a cost-benefit basis, once it is no longer expected to boost nominal demand. The cost of bailing out failed companies will be more transparent, as it will be obvious that more jobs in the rescued company are offset by fewer jobs elsewhere. Those claiming that Chinese exports cost jobs will have to provide a mechanism other than “less demand”, and won’t be able to do so. And, most importantly, countries will be able to address the public debt problem, as they should, without fear that austerity will cost jobs.

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