Ryan Bourne: Anti-Truss commentators should try to understand nominal GDP targeting

By Ryan Bourne

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Want an example of economic fatalism? Just read reactions to Liz Truss criticising the Bank of England's inflation performance.

Truss suggested that rocketing prices necessitates reviewing the Bank's mandate and learning from countries that haven't endured double-digit inflation despite global supply-shocks. Shrill commentators react with knee-jerk horror, as if this must mean politicians setting interest rates, sacrificing the Bank's independence and (heaven forfend) risking monetary credibility. Yes, the current regime might have delivered 9.4 percent inflation and rising, but why hope to do better? To question the Bank is to undermine it!

This is silly, of course. Credibility is earned. For the Old Lady, some soul-searching is necessary. With politicians talking about having to raise taxes to curb inflation, something has gone badly wrong. Whether it's the Bank's forecasting models, the 2 percent inflation target, or the tools used to hit it, the alleged advantages of central bank independence haven't materialised. Autonomy promised to insulate us from wishful forecasts and allow the Monetary Policy Committee (MPC) to take away the punchbowl before the party got out-of-hand. It didn't this time, on either count.

Team Truss doesn't have all the answers, but good on them for asking questions. An intriguing staffer's quote specifically implied she wanted to investigate changing the Bank's mandate from inflation targeting to a nominal GDP level target. This is something I'm convinced would be an improvement, but one unlikely to satisfy the Bank's most hawkish critics.

Right now, the Bank has a 2 percent inflation target. When a demand-shock raises aggregate spending and so prices, the Bank should tighten monetary conditions to offset this and keep inflation at bay. So far, so uncontroversial. The difficulty comes when a negative supply-shock such as an oil price surge or a major war disrupts supply-chains and raises costs. If the Bank is strictly targeting inflation, it should similarly tighten policy against this one-off price uplift, so that other non-oil prices fall, keeping annual inflation at bay.

In a world where some money wages are sticky (i.e. not fully flexible downwards), squeezing aggregate demand through tighter money on top of the worsened supply would reduce employment and output sharply. Pure inflation targeting therefore makes output more volatile when supply-shocks occur. The same is true inversely: if a new technology causes productivity to boom, lowering prices, then an inflation-targeting central bank must try to push the price level back up, eroding the consumer benefits of lower prices and exacerbating the business output cycle.

Central bankers are aware of this problem. The Bank's remit even allows it to give "due consideration to output volatility." When instances like the Ukraine war hit, the practical consequence is that we essentially abandon inflation targeting, with the Bank instead trying to parse supply-shocks from demand-shocks. They've proven poor at doing so arbitrarily, keeping demand policy too loose even accounting for supply problems.

The Bank governor won't admit this publicly, but we'd have above-target inflation today even if the war and pandemic hadn't cratered supply. Inflation is caused by too much money chasing too few goods, and we've suffered both squeezed production and excess demand. Not only have supply disruptions raised prices and lowered real output within money GDP growth, but the overall nominal GDP level (a good proxy for aggregate demand) has raced ahead of its pre-crisis trend. Monetary policy, by pushing spending higher, has therefore not just failed to counteract the rising price level caused by the war and pandemic, but has actively exacerbated inflation.

That rather uncomfortable truth – that the Bank should have tightened policy sooner to choke off excess demand, even if it tolerated supply-shocks – has not been articulated by Andrew Bailey. Yet last week's monetary report showed that the MPC will now slam on the demand brakes harder than its forecasts imply is necessary to return inflation to target. Presumably, this is an admission of past failures – an attempt to look tough and strengthen its inflation-fighting bonafides.

A nominal GDP level target is interesting because it would have avoided all this supply-demand confusion by crystallising the trade-offs into one, simpler target.

Rather than inflation at 2 percent per year, the Bank would aim for a steady growth in overall economy-wide money spending (nominal GDP, or aggregate demand). In essence, the Bank would only try to squeeze inflation out when demand was expected to rise above target.

When oil price spikes hit, that nominal GDP target would be composed of more inflation and less real output. Higher prices would be tolerated. In years when productivity growth was strong, such as through the pre-2008 period, nominal GDP would be made up of less inflation and more real output. The Bank would let consumers benefit from lower prices by running tighter policy than under inflation targeting.

Under this mandate, the Bank would have a greater clarity of purpose under supply-shocks, with a mandate that reduced output volatility. By just looking at nominal GDP, the MPC wouldn't need to second guess what price rises to ignore and what to react to. Overall spending would be its concern.

If this had been in place, the Bank would have been touching the brakes earlier through last year as indicators flashed that nominal GDP was surging and heading quickly above its pre-pandemic trend. Of course, nominal GDP itself is only estimated imperfectly and forecasts of it are often wrong. But issues of estimation aside, the Bank would have only worried about excess demand. To the disappointment of those who detest any periods of inflation above 2 percent, the Bank still wouldn't have tried to choke off the higher prices caused directly by the pandemic and Ukraine war.

This, in fact, raises an obvious disadvantage to making this mandate change now. It might risk being seen by markets and the public as merely "going soft" on inflation given our recent experience. Such a mandate would have probably led to tighter policy last year than we actually saw, but in principle it would be more tolerant of rising prices in the face of oil shocks than the inflation target we have on paper.

This nuance is one reason why a knee-jerk defence of the Bank's performance is so destructive. Mainstream commentators' wailing about Truss proposing a mandate change have ignored that she's actually pondering a pragmatic shift that would have aided the Bank to deliver what it tried to achieve, but didn't. Behind the tough talk and Bank criticism from Team Truss, this proposed mandate would be more forgiving than pure inflation targeting should be when oil prices spike, so is better suited to the difficult situation we've faced.

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