Better If Fed Targets Neither Inflation Nor Employment

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The Federal Open Market Committee is in a pickle. After its last meeting, it suggested that it would soon start raising interest rates as a way to head off inflation. Recent inflation numbers, showing an uptick in the core inflation rate, make that step seem as necessary as ever.

But disappointing growth projections, along with the dollar's international appreciation, are giving committee members cold feet.

The FOMC's dilemma is rooted in the Fed's so-called "dual mandate," calling for it to achieve both "maximum employment" and "stable prices." Whenever inflation and employment seem to be headed in opposite directions, the Fed has to compromise.

Wrong compromises aggravate the business cycle; and even if the compromises are correct, the Fed's uncertain direction puts a damper on growth.

Realizing its flaws, some favor just scrapping the dual mandate's "maximum employment" clause, leaving the Fed with a solitary inflation target.

The dual mandate's champions reply that, while inflation targeting might make monetary policy more predictable, it could also call for the Fed to tighten at times — the present might just be one of them — when doing so means putting the brakes on an already slowing economy.

So what's best, a slippery dual mandate or a stable-inflation straitjacket? Neither.

Because the real problem with the dual mandate is that it's not one but two mandates too many. Instead of trying to target either inflation or employment, the Fed ought to target the economy's overall level of spending or its statistical counterpart, NGDP, which stands for the dollar value of nominal gross domestic product.

A single NGDP mandate would serve just as well as a single inflation mandate in making monetary policy less arbitrary and more predictable.

Why should the Fed target spending rather than inflation? Because the Fed can better avoid, or at least dampen, the business cycle by stabilizing spending than by stabilizing inflation.

Excessively rapid spending sponsors booms by swelling business revenues and profits — or does so until costs catch up, driving up interest rates and turning boom into bust. Spending downturns, in contrast, bring immediate misery by causing overall business revenues to fall short of expenditures.

Fans of inflation targeting claim that it also avoids business cycles, but that's so only if an economy's productivity doesn't fluctuate much. Otherwise — if the same expenditure on inputs results sometimes in more and sometimes in less output — stable inflation means unstable spending, with all its bad consequences.

Keeping inflation constant despite a productivity setback just adds insult to injury by adding a money shortage to a shortage of real goods; doing so despite rapid productivity gains risks feeding an unsustainable boom instead of just allowing a sustainable one.

The latter scenario played out in the early 2000s, when the Fed allowed NGDP to grow more rapidly than usual, while a productivity surge kept inflation steady. Lately productivity has slumped, so raising interest rates might put the first scenario into play.

In short, although a stable inflation rate sounds like a good thing, it can actually be a recipe for trouble.

So why aren't economists calling for a single spending target? Actually, some are — though so far they are a small if growing minority. Though their plea for stable spending is sometimes couched in Keynesian terms, the group has become known as "market monetarists" because of their commitment to an unambiguous and strict monetary policy rule.

The market monetarists' acknowledged leader is Scott Sumner — an economics professor at Bentley University who is also director of the Mercatus Center's Program on Monetary Policy. He has been tirelessly promoting NGDP targeting since 2009 on his blog, "The Money Illusion."

David Beckworth, another prominent market monetarist, has been doing the same on his own blog, "Macro and Other Market Musings."

If NGDP targeting hasn't gotten the attention that it deserves, all this blogging may hold a clue as to why: The movement has embraced blogs because it's easier than making inroads into the upper reaches of academe, where the Fed tends to look for advice, if not for its leaders.

With luck, and some public encouragement, the Fed's Ivy League bias may yet be overcome. Alternatively, Congress itself can heed market monetarists' advice and amend the Fed's dual mandate accordingly.

That mandate has survived as long as it has, despite its many shortcomings, because it has yet to face a robust alternative. Now that such an alternative is on the table, there's no good reason for putting up with the sloppiness any longer.

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