

Update on Monetary Conditions: Spring 2024

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Intellectual diversity, promoted by its decentralized structure, with 12 Reserve Banks scattered across the country and the Federal Reserve Board in Washington, DC, was once one of the Federal Reserve's greatest strengths.¹ Today, by contrast, a troubling lack of diversity at the Fed appears as a significant liability.² One manifestation of this lack of diversity is a narrowness in the range of analytic approaches used by Federal Open Market Committee members to evaluate their monetary policy options and to communicate to the public the rationale for their decisions.

Within the Fed, the dominant framework for monetary policy analysis and evaluation is, always has been, and probably always will be the Keynesian one. According to the Keynesian view, the Fed conducts monetary policy by managing interest rates. Due to nominal price and wage rigidities, policy-induced movements in nominal interest rates translate into movements in real interest rates as well. Changes in real rates then induce consumers and businesses to

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¹ Michael D. Bordo and Edward S. Prescott, "Federal Reserve Structure and the Production of Monetary Policy Ideas," Working Paper 23-29 (Cleveland: Federal Reserve Bank of Cleveland, November 2023).

² David G. Blanchflower and Andrew T. Levin, "Diverse Views in Monetary Policy," International Monetary Fund *Finance and Development* 60 (March 2023): 28-31. Jeffrey M. Lacker, "Governance and Diversity at the Federal Reserve," Policy Brief (Arlington: Mercatus Center at George Mason University, January 2024).

rearrange intertemporally their spending plans. These changes in spending affect today's measures of aggregate resource utilization: the unemployment rate and the output gap. Finally, these changes in resource utilization drive movements in inflation. In that last step, the Phillips curve, describing an inverse relationship between unemployment and inflation, becomes the key mechanism through which monetary policy actions that start by affecting interest rates ultimately impact on the economy as a whole.

Two problems with this Keynesian approach have emerged over the past 15 years. The first problem stems from recurrent instability in the Phillips curve. From 2009 through 2019, as the US economy recovered gradually from the 2008 financial crisis, the unemployment rate declined to historically low levels. According to the Phillips curve, inflation should have accelerated, returning to the FOMC's two-percent long-run target. It did not. More recently, the FOMC has been trying to bring inflation back down, following its surge in 2021-2.³ According to the Phillips curve, this disinflation should have required a substantial increase in unemployment. So far, at least, it has not.

The second problem reflects the lack of intellectual diversity referred to earlier. With no other analytic framework to rely on except the Keynesian one, FOMC members have been left adrift by Phillips curve instability. They appear to be making policy decisions based mainly on guesswork. It's become increasingly difficult for them to explain to the public what they're doing and why. And it's become almost impossible to describe their contingency plan for how

³ For more detailed quantity-theoretic analyses of both the recent surge in inflation and the Fed's efforts to bring inflation back down, see Peter N. Ireland, "The Recent Surge in Money Growth: What Would Milton Friedman Say?" *Journal of Applied Corporate Finance* 34 (Spring 2022): 65-81; and Peter N. Ireland. "US Monetary Policy, 2020-23: Putting the Quantity Theory to the Test." *Journal of Applied Corporate Finance* 35 (Summer 2023): 42-8.

interest rates will have to adjust if something goes wrong: either if inflation remains stubbornly high or if unemployment does begin to rise sharply later in 2024.

Fortunately, there is an alternative framework for monetary policy analysis and evaluation that at least some FOMC members – if they do find value in diversity – might take and use “right off the shelf.” This alternative view is based on the idea that the Fed should control inflation by targeting nominal GDP, instead of relying on a potentially unstable Phillips curve. Its intellectual origins are monetarist, instead of Keynesian.

Some – though by no means all – of the arguments favoring nominal GDP targeting are as follows.⁴ First, nominal GDP is a nominal variable, measured in dollars or, more generally, “units of the local currency.” Nominal GDP is, therefore, under the Fed’s clear influence. Although the FOMC can’t control nominal GDP precisely on a quarterly or even an annual basis, through the appropriate choice of policy actions it can bring about any desired growth rate of nominal GDP, on average, over a period of several years.

At the same time, nominal GDP growth can be decomposed into an equally-weighted sum of aggregate price inflation and real GDP growth. Thus, by targeting nominal GDP, the Fed would automatically pursue modest stabilization objectives, as required by its statutory dual mandate, even as it controls long-run inflation. In this way, nominal GDP targeting is less ambitious, but more robust, than the Keynesian approach to policymaking that depends on a stable Phillips curve. It accepts that there will always be uncertainty as to how movements in aggregate spending will break down into real and nominal components in the short run. It therefore eschews some fine-tuning in favor of avoiding major policy mistakes.

⁴ For a more comprehensive list, see David Beckworth, “Facts, Fears, and Functionality of NGDP Level Targeting: A Guide to a Popular Policy Framework for Monetary Policy,” Mercatus Special Study (Arlington: Mercatus Center at George Mason University, September 2019).

Finally, the equation of exchange $MV=PY$ links nominal GDP, as the product of the aggregate price level P and real GDP Y on the right-hand side, to the money stock M on the left, while also accounting for shifts in monetary velocity V . As the counterpart to Phillips curve instability in the Keynesian model, instability in velocity is the “Achilles heel” of monetarism.⁵ But by targeting nominal GDP – “a velocity-adjusted monetary aggregate” – the central bank reacts adaptively, calibrating its policy decisions to offset shifts in V with appropriate changes in M .⁶ An added benefit of nominal GDP targeting is that, by refocusing some attention money growth, it places less emphasis on interest rates and thereby downplays the significance of the zero lower interest rate bound. Whether by traditional federal funds rate management or through large-scale asset purchases that expand the supply of bank reserves, monetary policy actions that stimulate broad money growth will generate faster growth in nominal GDP as well, both at and away from the zero lower bound.⁷

Ideally, the FOMC would implement a nominal GDP targeting strategy by following a specific, pre-announced monetary policy rule, according to which it would adjust the federal

⁵ Ben S. Bernanke and Alan S. Blinder, “Money, Credit, and Aggregate Demand,” *American Economic Review* 787 (May 1988), 435-9.

⁶ James Tobin, “Monetary Policy: Rules, Targets, and Shocks,” *Journal of Money, Credit, and Banking* 15 (May 1983): 506-18. Bennett T. McCallum, “On Consequences and Criticisms of Monetary Targeting,” *Journal of Money, Credit, and Banking* 17 (November 1985, Part 2): 570-97.

⁷ Peter N. Ireland, “Targeting Nominal GDP Through Monetary Control,” Manuscript (Chestnut Hill: Boston College, March 2024). See also Michael T. Belongia and Peter N. Ireland, “Circumventing the Zero Lower Bound with Monetary Policy Rules Based on Money,” *Journal of Macroeconomics* 54 (December 2017): 42-58; and Michael T. Belongia and Peter N. Ireland, “The Transmission of Monetary Policy Shocks Through the Markets for Reserves and Money,” *Journal of Macroeconomics* 80 (June 2024): Article 103590.

funds rate in response to forecasted deviations of nominal spending growth from target.⁸ Even in the absence of a consensus for a rule-based approach, however, any individual Governor or Reserve Bank President could restore some much-needed intellectual diversity to the FOMC’s policy deliberations simply by referring consistently in his or her public statements to nominal GDP as an indicator of the stance of monetary policy.

To illustrate how, the top panel of figure 1 plots year-over-year growth in nominal GDP since 2009. The graph summarizes nicely the evolution of both Federal Reserve policy and US economic performance over the past 15 years. It shows clearly the extended period of slow but stable nominal GDP growth extending from 2011 through 2019, followed by the sharp decline in nominal spending during the 2020 economic closures, and then the even more dramatic acceleration in nominal GDP growth reflecting the unwanted surge in inflation since 2021.

Most recently, nominal GDP growth has trended steadily downward. But will this trend continue? To help answer this question, the center panel of figure 1 plots year-over-year growth in the broad monetary aggregate M2. Despite movements in velocity (falling before 2020 and rising since then, as shown in the bottom panel of figure 1), fluctuations in money growth since 2009 have paralleled and anticipated subsequent movements in nominal GDP growth.⁹ Money growth remained slow but stable through 2019 before surging in 2020, providing a clear warning sign of the inflation that followed. M2 growth has since turned negative.

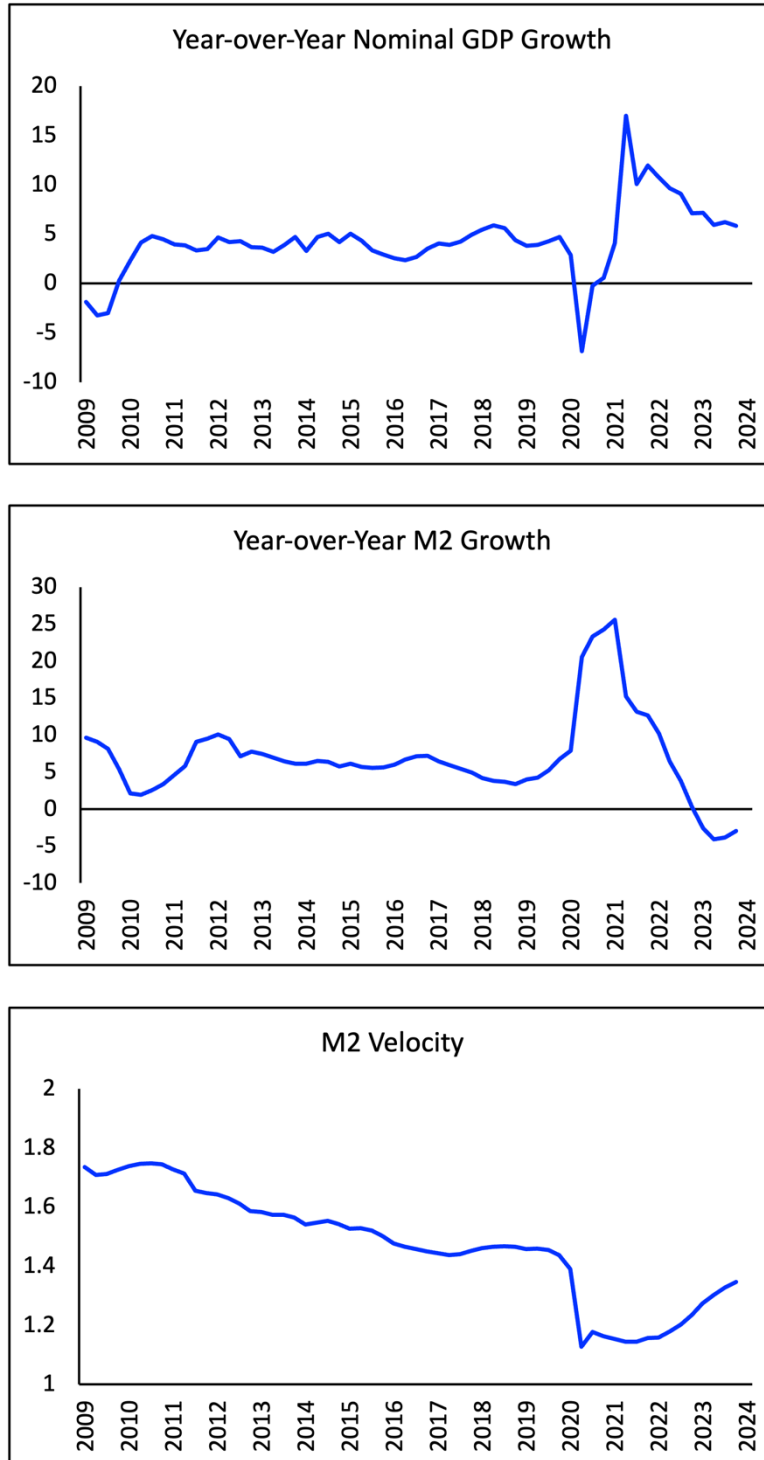
⁸ Athanasios Orphanides, “Enhancing Resilience With Natural Growth Targeting,” Working Paper 200 (Frankfurt: Institute for Monetary and Financial Stability at Goethe University, February 2024).

⁹ Again, for details, see Ireland, “The Recent Surge in Money Growth,” “US Monetary Policy, 2020-23,” and “Targeting Nominal GDP Through Monetary Control.”

With reference to these graphs, any FOMC member could reassure the public that the interest rate increases implemented by the FOMC in 2022 and 2023 have worked, as intended, to remove excessive monetary accommodation and thereby reduce inflationary pressures. And with continued reference to these graphs, any FOMC member could also explain that, going forward, the Committee's interest rate decisions will have to depend on the behavior of nominal GDP growth. A continuation of the downward trend in nominal GDP growth, especially if accompanied by continued monetary contraction, will allow the FOMC to begin reducing interest rates in the second half of 2024. A reversal in this trend, conversely, will signal the need for the FOMC to keep interest rates elevated for longer.

Comments like these would add much welcome elements of clarity and common sense to the Fed's communications with the public. More generally, monetary policy analysis built around the concept of nominal GDP targeting would provide a useful "cross check" against the more far popular Keynesian approach based on the Phillips curve. In this simple and easy way, diversity could once again become one the Fed's greatest strengths.

Figure 1. Quarterly US Data, 2009 - 2023



Source: Federal Reserve Bank of St. Louis, FRED database.