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Dear Ben: It's Time for Your Volcker Moment

By CHRISTINA D. ROMER

IN October 1979, inflation was running at more than 10 percent a year, and the Federal Reserve's gradual interest rate increases weren't solving the problem. So Paul Volcker, the Fed chairman, dramatically changed how monetary policy was conducted. Today, an equally intractable unemployment crisis demands that Ben S. Bernanke, the current Fed chairman, stage a quiet revolution of his own.

What did Mr. Volcker do? He reasoned that because inflation depends on growth in the money supply, inflation would fall if he brought that growth down. And he believed that by backing up his commitment to lower inflation with a new policy framework, he would break people's inflationary expectations. So the Fed began to explicitly target the rate of money growth.

Hitting that target required pushing interest rates to unprecedented levels. Unemployment rose past 10 percent, and Mr. Volcker was pilloried. At one point, farmers on tractors blockaded Fed headquarters to protest the high rates.

But the policy worked. Inflation fell from 11 percent in 1979 to 3 percent in 1983, and unemployment returned to normal levels. Even my father, who lost his job as a chemical plant manager in the 1981 recession, views Mr. Volcker as a hero. His bold moves ushered in an era of low inflation and steady output growth.

Today, inflation is still low, but unemployment is stuck at a painfully high level. And, as in 1979, the methods the Fed has used so far aren't solving the problem.

Mr. Bernanke needs to steal a page from the Volcker playbook. To forcefully tackle the unemployment problem, he needs to set a new policy framework — in this case, to begin targeting the path of nominal gross domestic product.

Nominal G.D.P. is just a technical term for the dollar value of everything we produce. It is total output (real G.D.P.) times the current prices we pay. Adopting this target would mean that the Fed is making a commitment to keep nominal G.D.P. on a sensible path.

More specifically, normal output growth for our economy is about 2 1/2 percent a year, and the Fed believes that 2 percent inflation is appropriate. So a reasonable target for nominal G.D.P. growth is around 4 1/2 percent.

Economic research showed years ago that targeting nominal G.D.P. has important advantages. But in the 1990s, many central banks adopted inflation targeting, a simpler alternative. As distress over the dismal state of the economy has grown, however, many economists have returned to the logic of targeting nominal G.D.P.

It would work like this: The Fed would start from some normal year — like 2007 — and say that nominal G.D.P. should have grown at 4 1/2 percent annually since then, and should keep growing at that pace. Because of the recession and the unusually low inflation in 2009 and 2010, nominal G.D.P. today is about 10 percent below that path. Adopting nominal G.D.P. targeting commits the Fed to eliminating this gap.

HOW would this help to heal the economy? Like the Volcker money target, it would be a powerful communication tool. By pledging to do whatever it takes to return nominal G.D.P. to its pre-crisis trajectory, the Fed could improve confidence and expectations of future growth.

Such expectations could increase spending and growth today: Consumers who are more certain that they'll have a job next year would be less hesitant to spend, and companies that believe sales will be rising would be more likely to invest.

Another possible effect is a temporary climb in inflation expectations. Ordinarily, this would be undesirable. But in the current situation, where nominal interest rates are constrained because they can't go below zero, a small increase in expected inflation could be helpful. It would lower real borrowing costs, and encourage spending on big-ticket items like cars, homes and business equipment.

Even if we went through a time of slightly elevated inflation, the Fed shouldn't lose credibility as a guardian of price stability. That's because once the economy returned to the target path, Fed policy — a commitment to ensuring nominal G.D.P. growth of 4 1/2 percent — would restrain inflation. Assuming normal real growth, the implied inflation target would be 2 percent — just what it is today.

Though announcing the new framework would help, it probably wouldn't be enough to close the nominal G.D.P. gap anytime soon. The Fed would need to take additional steps. These might include further quantitative easing, more forceful promises about short-term interest rates, and perhaps moves to lower the exchange rate. Such actions wouldn't just affect expectations; they would also be directly helpful. For example, a weaker dollar would stimulate exports.

Nominal G.D.P. targeting would make it more likely that the Fed would take these aggressive actions. Today, each Fed move generates controversy and substantial internal dissension. As a result, even though the central bank has taken some expansionary steps, they've often been smaller than needed and deliberately limited in duration.

Mr. Volcker faced a similar problem in October 1979. Each small rise in interest rates was a major battle. Committing to an overarching goal yielded more forceful action and less dissension within the Fed. Agreeing to a nominal G.D.P. target would do much the same today.

For evidence that adopting the new target could help fix the economy, look at the 1930s. Though President Franklin D. Roosevelt didn't talk in terms of targeting nominal G.D.P., he spoke of getting prices and incomes back to their pre-Depression levels. Academic studies suggest that this commitment played an important role in bringing about recovery.

President Roosevelt backed up his statements. He suspended the gold standard and let the dollar depreciate. He got Congress to pass New Deal spending legislation and had the Treasury monetize a large gold inflow. The result was an end to deflationary expectations, leading to the most impressive swing the country has ever seen from horrible contraction to rapid growth.

Would nominal G.D.P. targeting work as well today? There would likely be unexpected developments, just as there were in the Volcker period. But the new target would have a better chance of meaningfully reducing unemployment than any other monetary policy under discussion.

Because it directly reflects the Fed's two central concerns — price stability and real economic performance — nominal G.D.P. is a simple and sensible target for long after the economy recovers. This is very different from Mr. Volcker's money target, which was abandoned after only a few years because of instability in the relationship between money growth and the Fed's ultimate objectives.

Desperate times call for bold measures. Paul Volcker understood this in 1979. Franklin D. Roosevelt understood it in 1933. This is Ben Bernanke's moment. He needs to seize it.

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