The alternative explanation assumes that wage- and price-setting institutions have an inflationary bias. This bias arises because labor markets adjust slowly to changes in economic conditions. Wage rates often fail to reflect the availability of unemployed workers, either because of established relation- ships between employers and their workers or because of a lack of competitive pressure—sometimes shielded by foreign trade barriers. Some advocates of nominal income targeting who hold this view of labor markets propose that the strategy of a broader economic strategy that includes some form of labor-market reform or policies that would lead to more competi- tive behavior. “This involves in- creasing the power of the economi- cally disenfranchised outsiders, whose availability for work has little impact on the wages paid to the Federal Reserve Bank of Cleveland ISSN 0428·1276

Nominal Income Targeting
by John B. Carlson

In recent years prominent econ- omists from diverse schools of thought have urged policymakers to establish long-term targets for economic growth. The common thread that emerges from these proposals is to extend the announced policy horizon beyond one year, thus clarifying the longer-run impact of policy. In this Economic Commentary, we describe the current framework for monetary policy and suggest that a multi- year nominal income target could be viewed as a practical extension of current policy procedures. To be useful, a nominal income target for monetary policy would need to be credible and hence achievable over a reasonably predictable period of time. In this article we will identify some potential problems for nominal income control, particularly during periods of disinflation.

Semantics of Monetary Policy
The current framework for monetary policy is hierarchical, defined in terms of ultimate goals, inter- mediate targets, short-run or oper- ating targets, and policy instru- ments. The ultimate goals of economic policy—price stability and high-employment economic growth—are prescribed in the Full Employment and Balanced Growth Act of 1978. Commonly called the Federal Reserve Act of 1978, this act requires the Federal Reserve to report to Congress annual financial objec- tives—targets for monetary and aggregate credit growth—consistent with these ultimate goals. The reported monetary and credit objectives are intermediate targets that provide guidance for policy action. While not themselves the ultimate concern of policymakers, the behavior of the intermediate target variables provides information about the current and future levels of economic activity. Having intermediate targets is useful, because the transmission of mone- tary policy to ultimate policy targets is slow and uncertain. Another advantage to using some intermediate targets is that they can be observed more frequently than ultimate goals and hence provide more immediate feedback about the effectiveness of policy actions. The intermediate targets are rela- tively related to ultimate goals, policy actions that attain intermediate target values will therefore be compatible with ultimate goals. Specification of annual intermediate target values—often called the strategy of monetary policy—also provides a statement to the public about the intent of policy in the period ahead.

Intermediate targets, like ultimate goals, cannot be controlled closely in the very short run. Con- sequently, the Federal Reserve also establishes operating targets for var- iables that it controls closely, as reserve aggregates. The operat- ing targets provide guidance for the trading desk as it attempts to achieve the intermediate targets through open-market operations, a policy instrument. Operating targets must be reliably related to intermediate targets, just as interme- diate targets must be reliably related to ultimate targets. The oper- ating targets thus provide imme- diate feedback as to the consistency of policy actions with achievement of the intermediate objective. The specification of operating targets is sometimes called the tactics of monet- ary policy, to be distinguished from strategy (i.e., the specification of intermediate targets).

Since the fall of 1982, the oper- ating target has been discount- window borrowing. To achieve the targeted level of borrowings, the Federal Reserve conducts open-market operations (the instrument) that directly change the level of nonborrowed reserves. Total re- serves not supplied by open-market operations are created through

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John B. Carlson is a monetary economist at the Federal Reserve Bank of Cleveland. Kim Rowerishi, Mark Sniderman, and Ed Stevens provided valuable comments throughout the prepara- tion of this article. The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Gover- ners of the Federal Reserve System.
discount-window borrowing. The level of borrowings affects the opportunity cost of funds and, in turn, the growth of several mone-
yary aggregates (intermediate targets).

The Federal Reserve believes its monetary growth paths are consistent with price stability and high employment (ultimate goals). This policy is referred to as a monetary aggregate strategy with a discount-window-borrowing tactic.

To summarize, the hierarchical structure of monetary policy presumes imperfect, indirect, dynamic links between instruments and ultimate goals. Targets, both operating and intermediate, are useful only insomuch as they provide a standard against which the Federal Reserve can assess the actual behavior of the operating and intermediate variables. When these variables deviate from their target paths, the Federal Reserve systematically will conduct open-market operations in a manner designed to realign variables with target settings. In pursuing its targets, the Federal Reserve takes into account all information, including behaviors of nominal income, relevant to achieving high-income growth and price stability.

Price Stability

Federal Reserve Chairman Paul A. Volcker has described price stability as "a situation in which expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic or financial behavior. Stated more positively, 'stability' would imply that decision making could be facilitated on the basis that 'real' and 'nominal' values are substantially the same over the planning horizon—and that planning, a veritable monetary target is indistinguishable from a nominal income target.

Nominal Income as a Policy Strategy

Given the current framework for monetary policy, it is not surprising that policymakers seek to create an environment that generates adequate incentives for saving and capital formation. New capital increases the capacity of the economy to produce, allowing additional output with less risk of inflation. In principle, nominal income targets would be chosen to accommodate sufficient demand over the longer term to encourage capital formation. Other government policies would also affect capital formation. For example, if the government expenditure claims a greater share of output, and hence the resources used to produce this output, fewer resources are available for private use. If the central bank maintained an unchanged nominal income target, then additional government spending would come from either private consumption or investment. If such spending displaced investment, then the future capacity of the economy would be reduced.

It is not clear that a higher nominal income target would resolve this problem. Resources become fully employed, nominal income might approach its longer-run path. Raising (or even abandoning) the nominal income target might temporarily attract additional resources into production, but resources ultimately would accumulate only if the problem is not one specific to nominal income targeting, but to any nonflationary income. In this case, the Federal Reserve's inventory investment crowds out resources available for private investment.
That is, price stability is defined in terms of the economic implications of expected price changes. Volcker’s concept stresses the future horizon to the point where inflation can be judged by policymakers. The Federal Reserve believes its monetary growth paths are consistent with price stability and high employment (ultimate goals). This policy is referred to as a monetary aggregate strategy with a discount-window-borrowing tactic.

To summarize, the hierarchical structure of monetary policy presumes imperfect, indirect, dynamic links between instruments and ultimate goals. Targets, both operating and intermediate, are useful only insomuch as they provide a standard against which the Federal Reserve can assess the actual behavior of the operating and intermediate variables. When these variables deviate from their target paths, the Federal Reserve systematically conducts open-market operations in a manner designed to realign variables with target settings. In pursuing its targets, the Federal Reserve takes into account all information, including behavior of nominal income, relevant to achieving high-income growth and price stability.

Price Stability
Federal Reserve Chairman Paul A. Volcker has defined price stability as a “situation in which expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic or financial behavior. Stated more positively, stability suggests the importance of anticipated future influences on the economy, including economic policy.

The Federal Reserve currently announces its monetary and credit objectives for at most 18 months ahead. The announcement—made by the chairman of the Federal Reserve to Congress in July—indicates preliminary intermediate targets for the coming year. The Federal Reserve is not obligated to adopt those targets at the beginning of the next year if new information indicates that the preliminary targets are inappropriate. Thus, the specified policy horizon is interpreted as annual.

Caveat Deficit
Another problem raised by opponents of nominal income targeting concerns the potential for central bankers, policymakers seeking to create an environment that generates adequate incentives for saving and capital formation. New capital increases the capacity of the economy to produce, allowing additional output with less risk of inflation. In principle, nominal income targets would be chosen to accommodate sufficient demand over the longer term to encourage capital formation. Other government policies would also affect capital formation. For example, when federal government expenditures claim a greater share of output, and hence the resources used to produce this output, fewer resources are available for private use. If the central bank maintained an unchanged nominal income target, then additional government spending would come from either private consumption or investment. If such spending displaced investment, then the future capacity of the economy would be reduced. It is not clear that a higher nominal income target would resolve this problem. As resources become fully employed, nominal income could approach its long-run path. Raising (or even abandoning) the nominal income target may temporarily attract additional resources into production, but prices ultimately would adjust. Inflation on the job problem is not one specific to nominal income targeting, but to any nominalization policy. A high rate of inflation crowds out resources available for private investment.

Nominal Income as a Policy Strategy
Given the current framework for monetary policy, it is not surprising that opponents of nominal income targeting would seek the benefits that might result from a credible expansion of the announced intermediate target horizon. Adoption of a nominal income target would seem a natural extension of the current hierarchical, multistage structure for monetary policy decisions. Like the behavior of monetary measures, the behavior of nominal income is easy to explain to the public and to Congress. Multiyear nominal income targets thus could serve to aid the public in understanding the intent of complex policy decisions. Because the economic benefits of price stability depend on the public’s confidence that real and nominal values will be substantially the same over suitably long horizons, it is essential that the public clearly understand the intent of policies in terms of a nominal variable over the longer term.

Multiyear targets for nominal income need not be irreparable. A high degree of reluctance implies that targets should be revised (although infrequently) under justifiable circumstances. For example, nominal income targets might be revised in the face of sizable supply-side shocks of the type experienced by the United States in 1973 and 1979, but not for more readily reversible shocks such as those related to market harvest variabilities. Analysts argue that maintaining nominal income targets over multiyear horizons should enhance the Federal Reserve’s credibility in controlling inflation. If controlling inflation were the only ultimate objective, a nominal income strategy—because it would imply that the intermediate target would be revised only because of an unanticipated change in the trend of real output—would be credible policy.

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Qualifications
Advocates of nominal income targeting argue that the policy is not a panacea but as a practical improvement to current practice. If a nominal income target were to serve any useful purpose, it must be credible. Thus, the Federal Reserve would need to achieve targeted values for nominal income in a reasonably predictable amount of time. Some opponents of nominal income targeting argue that the policy is not a panacea but as a practical improvement to current practice. If a nominal income target were to serve any useful purpose, it must be credible. Thus, the Federal Reserve would need to achieve targeted values for nominal income in a reasonably predictable amount of time. Some opponents of nominal income targeting argue that the policy is not a panacea but as a practical improvement to current practice. If a nominal income target were to serve any useful purpose, it must be credible. 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1. See Meade (1978), Tobin (1990, 1987), Stein (1992), Fellner (1976), and Hall (1985). Gordon essentially advocates a final spending target. The various proposals also differ on whether to target levels or rates of change, an issue that is not considered here.