A conversation with Dr. Scott Sumner, June 3, 2015

Participants

- Dr. Scott Sumner – Director, Program on Monetary Policy, the Mercatus Center at George Mason University (Mercatus)
- Alexander Berger – Research Analyst, Open Philanthropy Project
- Karl Smith – Consultant, Open Philanthropy Project

Note: These notes were compiled by the Open Philanthropy Project and give an overview of the major points made by Dr. Scott Sumner.

Summary

The Open Philanthropy Project spoke with Dr. Sumner of Mercatus as part of its investigation into the economic and policy advocacy landscape around nominal gross domestic product (NGDP) targeting. Conversation topics included support for NGDP targeting from economists, past obstacles to implementing NGDP targeting, the value of prediction markets, and Dr. Sumner's role at Mercatus.

NGDP targeting

Support for nominal GDP targeting

Dr. Sumner believes that the Federal Reserve (Fed) is likely to adopt a particular monetary policy if there is consensus among economists about its effectiveness. There is now significant support for NGDP targeting from well-known economists on both the left and the right, including:

- Christina Romer (University of California, Berkeley)
- James Bullard (President, Federal Reserve Bank of St. Louis)
- In recent remarks, Larry Summers (Harvard University) seemed to view NGDP targeting positively, though he did not explicitly endorse it
- Mark Carney suggested that NGDP targeting should be considered as an option, just before he began serving as Governor of the Bank of England

Dr. Sumner sees interest in NGDP targeting increasing steadily.

The UK may be the country most likely to adopt NGDP targeting in the near future.

Past obstacles to adopting NGDP targeting

Widely used New Keynesian economic models do not include NGDP as a variable, which makes it harder for many economists to see NGDP targeting as optimal.

The theoretical debate over the relative importance of wage and price stickiness is likely a factor that has influenced some economists towards favoring inflation targeting. Empirical models that view price stickiness as the main issue would point to inflation targeting, while models that view wage stickiness as more important (which is Dr. Sumner's view) point to NGDP targeting.

Decision not to adopt NDGP targeting in 2012

After Michael Woodford (Columbia University) endorsed NGDP targeting in 2012, The Fed considered adopting it but ultimately decided not to do so. The Fed may have been concerned that adopting NGDP targeting so soon after having committed to 2% inflation targeting could damage its credibility. Dr. Sumner suggests that, to help avoid a credibility issue, it might be beneficial to incrementally introduce NGDP targeting policies without abandoning inflation targeting entirely.

Around this time, advocacy from Dr. Sumner and others was mainly for NGDP level targeting. The Fed has traditionally been very reluctant to adopt level targeting, which is seen as a radical step for a central bank. If the Fed were to adopt level targeting, it might receive the majority of the blame for any missed targets.

Proposal for self-review by the Fed

Dr. Sumner believes it could be beneficial for Congress to require the Fed to periodically evaluate past decisions (e.g., after a year or 18 months) and vote on those decisions' effectiveness in hindsight. The Fed would then issue a formal statement on, e.g., whether its policies had been too expansionary or contractionary, or whether faster or slower growth in aggregate demand would have been preferable. This kind of review process could offer a clearer picture to Congress and the general public of how close economic variables are to the Fed's targets.

Prediction markets

Dr. Sumner believes that prediction markets are potentially very important and beneficial, and he supports the creation of a prediction market by the Fed (trading on NGDP, real GDP, and other key economic variables) for the purpose of economic research. A prediction market run by the Fed could offer far more prize money than current, smaller prediction markets do. Members of the Fed have expressed some uncertainty about whether the Fed is authorized to set up a prediction market, since there are currently no specific rules in place about it.

Potential impact of prediction markets on policy

Assuming that a prediction market is used to guide policy, it could be a very impactful investment. For example, if the Great Recession cost about $1 trillion, an information-gathering research strategy (such as a prediction market) that improved Fed policy to close 1% of that gap could represent $10 billion in savings. A prediction market might cost less than $1 million to set up.

The Fed seems to consider the Treasury inflation-protected securities (TIPS) Spread (a comparison of the yields of TIPS and conventional Treasury bonds which can serve as a market forecast of inflation) to be a useful source of information; this suggests that a prediction market for NGDP could be even more useful to monetary policymakers, as NGDP is a much more precise indicator than inflation of aggregate demand and spending. However, it is possible that policymakers could ignore prediction markets in setting policy. In September 2008, the Fed disregarded the

TIPS Spread's prediction of low inflation, arguing that the TIPS Spread was distorted by the greater demand for conventional bonds than for TIPS during financial crises.

It is important to put pressure on the Fed to adopt policy stances that are likely to be successful. The existence of a deep, liquid prediction market for NGDP during the Great Recession might have put pressure on the Fed to take more significant action. Prediction markets that provide the media with more accurate and dynamic evidence about the economic situation might better incentivize the Fed to act to prevent negative outcomes for NGDP (or other variables).

Existing NGDP prediction markets

Hypermind

Hypermind is a prediction market in which traders use play money to buy and sell shares but can win cash prizes through successful trading. (Using play money for trading ensures that Hypermind does not violate gambling laws or Securities and Exchange Commission regulations.) Dr. Sumner raised the $10,000 in prize money for Hypermind's first year running an NGDP market from a single donor. Offering more prize money would likely increase market liquidity.

iPredict

iPredict is a real-money prediction market in New Zealand that trades on political and economic issues. The funding raised for iPredict by Dr. Sumner has so far been used to subsidize trading so that traders do not have to pay commissions or bank fees, rather than used to award prizes. iPredict has been somewhat slow getting set up.

Mercatus

Dr. Sumner was recently brought on by Mercatus as director of its new Program on Monetary Policy. His work at Mercatus includes:

- Promoting the writing of empirical or theoretical research papers on monetary policy topics such as NGDP targeting
- Writing a book, based in part on his blog
- Giving talks and potentially hosting a conference

Mercatus is more of an academic research center than a political think-tank.

It might be useful for someone to fund a project similar to Dr. Sumner's program at Mercatus, but from a more center-left political perspective. It could be beneficial to frame NGDP targeting as a bipartisan proposal in general (e.g., left-leaning and right-leaning researchers or think tanks could present research jointly to Congress, or host a joint conference on the topic).