

Watching Nominal GDP

Brian S. Wesbury – Chief Economist
Robert Stein, CFA – Dep. Chief Economist
Strider Elass – Economist

One of the most important foundations of modern macroeconomics is something called the “equation of exchange.” It dates all the way back to John Stuart Mill but, in the past couple of generations, was popularized by free-market icon Milton Friedman.

It’s really quite simple: $M*V = P*Q$. And what it means is that the amount of money multiplied by the velocity with which it circulates through the economy determines nominal GDP (real GDP multiplied by the price level). For example, if the money supply increases and velocity stays the same (or rises), then nominal GDP will also increase, meaning more real GDP, higher prices, or some combination of the two.

This is true regardless of a country’s monetary system. It even worked under the old gold reserve system before the Federal Reserve was created in 1913. Back then, the government only created more dollars when someone deposited more gold. So, as long as velocity didn’t change, nominal GDP would grow at the same rate as the amount of gold. For example, if gold quantities rose, say 1%, per year and real GDP rose 3% per year, prices would fall 2% per year. This would have been “good” deflation. But in reality, velocity has tended to rise over time, so harmful deflation rarely occurred.

Frequent readers of our pieces know we often discuss nominal GDP and may wonder why. The simple reason is the “equation of exchange.” Nominal GDP is inextricably linked with monetary policy (and velocity) and knowledge of some parts of the equation let us solve for other parts.

Nominal GDP is up at a nearly 4% annual rate the past two years. As a result, we can say with some certainty that monetary policy must be accommodative. This is confirmed by a near zero federal funds rate and a relatively steep yield curve – meaning a wide spread between long- and short-term interest rates. In addition, the “real” (inflation-adjusted) federal funds rate has been negative for almost four years (average -0.7% for the past decade).

All of this signals monetary policy is loose. As a result, barring some unforeseen drop in velocity, we are forecasting an upward trend in nominal GDP growth over at least the next couple of years. In turn, as nominal GDP accelerates, the current stance of monetary policy will become increasingly inappropriate and the yield curve will steepen further. In other words, tapering and tightening are the right policies.

Some argue that the US is following the path of Japan. Nominal GDP in Japan is the same today as it was in 1991. Literally, zero growth in 22 years. But, the US is not Japan.

Japan’s population is shrinking, with more deaths than births and just slight immigration. This reduces output unless offset by productivity growth. As a result, the same level of short-term rates means Japan’s monetary policy is not as accommodative as in the US (where population is increasing). Comparing the two countries can lead to mistakes in analysis.

In the end, the point to understand is that fears of declining nominal GDP (or deflation) in the US are misplaced. The US is not Japan and the equation of exchange suggests we won’t be.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-1 / 9:00 am	ISM Index – June	50.5	50.0	50.9	49.0
9:00 am	Construction Spending – May	+0.6%	+0.8%	+0.5%	+0.4%
afternoon	Total Car/Truck Sales – June	15.4 Mil	15.6 Mil		15.2 Mil
afternoon	Domestic Car/Truck Sales – June	12.0 Mil	12.2 Mil		12.0 Mil
7-2 / 9:00 am	Factory Orders – May	+2.0%	+2.0%		+1.0%
7-3 / 7:30 am	Initial Claims - Jun 29	345K	345K		346K
7:30 am	Int’l Trade Balance – May	-\$40.2 Bil	-\$40.1 Bil		-\$40.3 Bil
9:00 am	ISM Non Mfg Index – Jun	54.0	54.3		53.7
7-5 / 7:30 am	Non-Farm Payrolls – Jun	165K	170K		175K
7:30 am	Private Payrolls – Jun	175K	175K		178K
7:30 am	Manufacturing Payrolls – Jun	0K	-2K		-8K
7:30 am	Unemployment Rate – Jun	7.5%	7.6%		7.6%
7:30 am	Average Hourly Earnings – Jun	+0.2%	+0.2%		+0.0%
7:30 am	Average Weekly Hours – Jun	34.5	34.5		34.5