

Why Nominal Spending Matters

Business people, traders, banks and many others pay attention to GDP releases, and rightly so. Following GDP data is among the best ways of getting a quick, no-nonsense read on the economy's recent state and forward momentum. This said, the figure most people focus on, and the only figure the financial media typically report, is “real” GDP, this is a shame.

Real GDP of course matters, but it's usually less interesting than nominal GDP, an indicator so important we decided to name our company after it.

Nominal GDP is the total dollar spending on final goods and services within a country's borders in a given timeframe, usually a year. It equals total dollar income and total dollar output – making up the other two of the three complementary methods for calculating the figure.

Real GDP is a composite, statistical concept; the result of 'deflating' the nominal GDP series by a broad price index—the GDP deflator. Because real GDP leans on this GDP deflator index so much, because it relies on the index weights being appropriately adjusted, and prices in the index properly measured and adjusted for quality changes in goods in services, it's hard to be terribly confident as to what small changes in real GDP actually mean.

Real GDP is best thought of as a production index, rather than in the dollar terms statistical agencies typically report. The idea of a production index sets the tone right away; tells the analyst that he is looking at something ambitiously attempting to measure the overall 'size' of something (the economy) which isn't easily summarized by a single figure. Nominal GDP, on the other hand, can actually be measured, something unambiguously happening in the real world: final spending. It also happens to be something business leaders and investors care deeply about: dollars/pounds/yen. An executive isn't evaluated on his company's inflation-adjusted profits, but the company's actual profits. The green paper shareholders have a right to at the end of the day, and that justifies employee bonuses.

Real GDP growth is good for evaluating production over long periods of time, five years, 10 years, 30 years. It's useful for policy makers and social scientists who want to track living standards or productivity. But for the business community, who need a certain amount of 'near term' focus if they're to see their organizations into the 'long term', nominal GDP is far more important. Here's why:

1. Nominal GDP matters for earnings and revenue. If nominal GDP doesn't grow, revenue can only be increased by taking market share from competitors, or diverting customer spending from other industries into your own. It's true that weak or negative nominal GDP growth will be followed by slower inflation or even deflation, making each dollar stronger, but it's also the case that this disinflation comes at a cost of economic disequilibrium, particularly if the weak nominal growth was not foreseen by businesses or households. Disequilibrium here means high unemployment and reduced purchasing power by would-be customers.
2. There is one particularly nasty consequence of weak or negative nominal GDP growth. It is caused by the well-established fact that wages are sticky downwards. Wage deals have a practical zero lower bound whereas overall wage costs do not. When revenues are weak or negative firms find themselves with no alternative but to cut jobs. Downwardly sticky wages is the prime transmission mechanism of weak nominal GDP into recessions. Overshooting on the upside does not have anything like as bad consequences. Central banks should always err on the upside in targeting inflation.

3. Nominal spending is something the central bank can actually control. Why is nominal spending growth bound, in developed countries, within a fairly narrow range around 4% per year? Why not 10%? Why not 100%? The answer is because the supply of money to be spent is managed by the central bank. The central bank can, in principle, move spending growth anywhere it likes. There will certainly be undesirable consequences from extreme moves in nominal growth, but the point is that nominal spending is the rudder the central bank uses to steer the economic ship. It's the only thing the central bank can do much about, the first and last move in the economy and the thing you ought to pay attention to

So next time you use a payment card or hand a shop clerk cash, take note. You've just participated in the ensemble that nominal GDP measures.