In the revolving door of economic ideas, the old can be suddenly new again. Independent Senator Nick Xenophon resurrected one such idea this week. He said the Reserve Bank of Australia should replace its inflation target of 2-3% per annum with a target of nominal GDP growth of around 5.5% per annum.

This is more than just an armchair economics debate – it could seriously affect all households and businesses in Australia.

First, a short primer. The RBA determines the general level of interest rates that we all pay on loans and earn on deposits. It has no legislative power to directly set rates, but it might as well have because its indirect control is so precise via other legislative requirements on banks.

The RBA's aim is to restrict inflation – the average rate of increase in prices – to a band between 2 and 3% over a period of years between economic booms and downturns. Why 2-3%? Because too much inflation is bad, and so is too little inflation. 2-3% is the sweet spot.

A higher rate of inflation (remember it's an average) means some prices are going up more than others creating uncertainty about future costs and selling prices, which discourages investment expenditure. Higher inflation also encourages speculative investments in housing and other assets, which can create speculative bubbles. And as we know, bubbles can burst.

Inflation that is too low, say 0-1%, means some businesses are selling at prices that are stagnant or falling, but their debts are not falling. That leads to difficulty in meeting debt repayments. So if the RBA thinks inflation is heading up beyond its target, it will raise interest rates to stop households and businesses borrowing and spending, which reduces pressure on prices. If it thinks inflation is too low it will cut rates to encourage us all to borrow and spend.

Now back to Xenophon's idea. He, and some respected economists before him, think inflation is the wrong target. What if, they argue, inflation is going up only because energy prices are going up? High energy prices can't be good news for businesses and households. So why would the RBA want to make life even harder by raising interest rates to lower inflation? Madness they say. Better to target the sum of the inflation rate plus the growth in national

output of goods and services (GDP), what is called nominal GDP growth.

So if inflation is going up but output is going down because of the depressing effect of high energy prices, nominal GDP would be flat and the RBA would do nothing, neither contracting nor expanding nominal GDP growth – the right policy.

Economists are split on this and have been for years. In August 2011 The Economist newspaper decided it was a good idea, and then three months later published an article against the idea. This is not unusual in economic debates incidentally – many economic "principles" are in fact contested, as is the case for most social sciences.

One big problem with Xenophon's idea is that the theory does not fit the times. It is not the right policy for today.

Energy prices are not going up; they have been falling and are now flat. Yes, electricity prices have been going through the roof in South Australia and to a lesser extent elsewhere. But oil prices have been falling or flat over recent years, and this has a more pervasive effect than government bungling of the electricity market.

So output growth and inflation are not moving in opposite directions – both have fallen in recent years. Inflation is now below the bottom of the RBA's target zone of 2-3% on any of the alternative measures.

The RBA, along with most central banks of advanced countries, would actually like to see more inflation, not less. Annual output growth is struggling to reach 3%, which is below the long run average of 3.5%. Hence nominal GDP growth is below the 5.5% long-run average that Xenophon would target. So whether the RBA targets inflation or nominal GDP growth doesn't matter – the policy would be the same – that is, stimulate spending by lowering interest rates, which is exactly what it has been doing.

Another downside is that although nominal GDP growth would be more stable, inflation would

tend to be more volatile. Inflation could jump up and down, but as long as output growth moved in the opposite direction the RBA would do nothing to dampen the volatility in inflation. Volatile inflation increases the uncertainty about future prices, which inhibits investment spending by firms and households.

A bigger problem with the RBA's inflation target that would not be resolved by adopting a nominal GDP target, is that the inflation target only refers to prices of goods and services – it ignores asset price inflation. The rapid rise in house prices in Sydney and Melbourne in recent years is a potentially serious problem that has been essentially ignored by the RBA. A better idea than nominal GDP targeting would be to include asset prices as well as the prices of goods and services in its inflation target.

And finally, if a nominal GDP target is such a good idea, then why is no country doing it? It is within the charter of most central banks to target nominal GDP growth instead of inflation, but none are, at least not formally.

Many central banks look at wider economic conditions as well as inflation. They will temporarily tolerate higher inflation when output growth, but the inflation rate remains their primary target. This flexibility seems reasonable, keeping inflation as the primary target. We would be the first to experiment with a strict nominal GDP target. Do we really want our Reserve Bank to be the world's guinea pig?

Ross Guest has in the past received ARC funding but is not currently in receipt of any such funding.

Read more http://theconversation.com/explainer-why-some-economists-think-the-rba-should-drop-its-inflation-target-64265