Of Kiwis and currencies: How a 2% inflation target became global economic gospel

By Neil Irwin
December 21, 2014 – *The New York Times*

Sometimes, decisions that shape the world's economic future are made with great pomp and gain widespread attention. Other times, they are made through a quick, unanimous vote by members of the New Zealand Parliament who were eager to get home for Christmas.

That is what happened 25 years ago this Sunday, when New Zealand became the first country to set a formal target for how much prices should rise each year — zero to 2 percent in its initial action. The practice was so successful in making the high inflation of the 1970s and '80s a thing of the past that all of the world's most advanced nations have emulated it in one form or another. A 2 percent inflation target is now the norm across much of the world, having become virtually an economic religion.

A core piece of the Japanese government's strategy to jolt its economy to life is to do "whatever it takes" to get to that magical 2 percent inflation level. In the United States, the same rationale has driven the Federal Reserve to keep interest rates near zero for six years and to pump nearly $4 trillion into the economy by buying bonds. The European Central Bank appears on the verge of its own huge effort to bring inflation closer to 2 percent.

Yet even as the idea of a 2 percent target has become the orthodoxy, a worrying possibility is becoming clear: What if it's wrong? What if it is one of the reasons that the global economy has been locked in five years of slow growth?

Some economists are beginning to consider the possibility that 2 percent inflation at all times leaves central banks with too little flexibility to adequately fight a deep economic malaise.

To understand that thinking, it's worth understanding how New Zealand's 2 percent target became so entrenched in the world economic order to begin with. The story starts in that Southern Hemisphere nation in the summer of 1989, with a kiwi farmer and banker named Don Brash.

When Mr. Brash stepped down as managing director of the New Zealand Kiwifruit Authority to lead the country's central bank in 1988, he was taking the helm of an economy that had been through a rough two decades, with high inflation and disappointing growth.

Mr. Brash tells the story of an uncle who sold an apple orchard in 1971 and put the money into long-term government bonds to finance his retirement, only to see inflation wipe out 90 percent of his life savings by the time the bonds matured.

In the years before Mr. Brash took the helm of the central bank — the Reserve Bank of New Zealand — his predecessor had made progress in bringing down inflation and making the bank more independent from the whims of politicians. But that independence had not been codified in law.

That's what the Reserve Bank Act of 1989 was supposed to do. It directed the finance minister and the head of the central bank to arrive at a formal target for how high inflation should be, and granted the central bank political independence to guide interest rates to achieve that inflation level. The head of the central bank could be dismissed for failure to reach the inflation goal.

For David Caygill, New Zealand's finance minister at the time, the essential part of the law was establishing the bank's independence from the political process. "Inflation targeting wasn't from our point of view the main point of the act," he said in an interview this month.

The debate over the legislation was contentious. Labor unions feared that focusing so pointedly on inflation would lead to higher unemployment. Some business interests agreed. “This is wrong in principle, undemocratic and inflexible,” the New Zealand Manufacturers’ Federation said in a statement in July 1989.

Mr. Brash wrote in his memoir that one prominent real estate developer “called publicly for me to announce my body weight, so that he could work out how much rope would be needed to hang me from a lamppost in Lambton Quay,” referring to the downtown area of Wellington, New Zealand’s capital.

Ultimately, however, the leaders of the majority party in Parliament decided to brush off the concerns. It helped the cause that one of the bill’s strongest opponents was laid up in the hospital. And Christmas was around the corner.

Once the law was enacted, though, there was the difficult question of what the inflation target should be. Zero percent? Two percent? Five percent?

Mr. Brash and Mr. Caygill got a head start on an answer from an offhand comment made during a television interview in 1988. Roger Douglas, Mr. Caygill’s predecessor as finance minister, had been seeking to dissuade New Zealanders from thinking that the central bank would be content with high inflation, and so he said in an interview that he was aiming for inflation of around zero to 1 percent.

“It was almost a chance remark,” Mr. Brash said in a recent interview. “The figure was plucked out of the air to influence the public’s expectations.”

With Mr. Douglas’s figures as a starting point, Mr. Brash and Mr. Caygill agreed that it would be best to expand the range to give them more room to maneuver, but only a bit. New Zealand would aim for inflation between zero and 2 percent.

Not surprisingly, the passage of a law to reform the central bank governance of an archipelago of 3.4 million people received no coverage in the major American papers. But across the close-knit world of global central bankers, people started to notice the Kiwis’ monetary policy experiment.

At the time, the idea of a central bank simply announcing how much inflation it was aiming for was an almost radical idea. After all, central bankers had long considered a certain man-behind-the-curtain mystique as one of their tools of power.

The inflation goal may have reduced that mystique, but it created a kind of magic of its own. Merely by announcing its goals for inflation, and giving the central bank the independent authority to reach that goal, New Zealand made that result a reality. In negotiations over wages or making plans for price increases, businesses and labor unions across New Zealand started assuming that inflation would indeed be around 2 percent. It thus became self-fulfilling, with wages and prices rising more slowly.

Inflation was 7.6 percent at the end of 1989 when the law was passed. By the end of 1991, it was 2 percent. Mr. Brash did a bit of a global campaigning, describing New Zealand’s success to his fellow central bankers at a conference in Jackson Hole, Wyo. — and to anyone else who would listen.

One by one, more countries adopted the approach. Canada, grappling with persistently high inflation, set an inflation target of 2 percent in 1991. Countries including Sweden and Britain soon followed.

Britain takes its 2 percent target seriously enough that the governor of the Bank of England has to write a letter to the chancellor of the Exchequer, explaining whenever inflation misses by more than a percentage point in either direction — the economic policy equivalent of a naughty student writing an apology on the blackboard.

But the more that countries set about announcing a target, the more keen was the discussion about the actual number.

One view was that zero inflation should be the goal — that a dollar today should have the same buying power as a dollar in a decade, or two or three. That was the view embraced by, among others, Paul A. Volcker, the former Fed chairman. Alan Greenspan, Mr. Volcker's successor at the Fed, argued that inflation needed to be low enough that it didn't have to be factored into business decisions.

Either of those approaches would imply that a proper target would be zero, or perhaps 0.5 percent or 1 percent, given the difficulty of measuring inflation precisely.

But there was an alternate view — that keeping inflation that low might be dangerous. And the person mounting that argument most forcefully within the Federal Reserve in the 1990s was a Fed governor named Janet L. Yellen.

Behind the oversize doors of the Federal Reserve's boardroom on Constitution Avenue in Washington, the fight over whether the world's largest economy should emulate the likes of Canada and New Zealand took place in 1995 and 1996.

Ms. Yellen, who now runs the institution, worried that announcing an inflation target would make the Fed focus only on inflation and neglect its responsibilities to bolster growth and jobs. She worried that zero inflation could paralyze the economy, particularly during slumps, and felt that some inflation was necessary.

"To my mind the most important argument for some low inflation rate is the 'greasing-the-wheels argument,"' Ms. Yellen said in a closed-door meeting of Fed policy makers in July 1996.

When businesses run into rough times, they may be inclined to cut workers' pay. But in practice, that doesn't happen much. Even in a severe downturn, businesses are more likely to cut hours, conduct layoffs or keep positions vacant than cut pay. That's one reason recessions tend to lead to higher unemployment instead of lower wages.

Inflation helps deal with this problem. When there is a bit of inflation, employers can hold workers' pay steady during a downturn yet have it decline in inflation-adjusted terms. Inflation creates an adjustment mechanism: An assembly line worker may keep making exactly $20 an hour through a downturn, but in inflation-adjusted terms that pay falls by 2 percent a year, which could make the factory less likely to resort to layoffs.

In that 1996 debate, another argument that Ms. Yellen raised against a zero percent target was particularly prescient. The higher the level of inflation, the more that central banks can stimulate the economy during a downturn.

Imagine that there is a severe recession and the Fed cuts interest rates to zero, so that when you put money in the bank you get no return. If there is no inflation, your money will retain its purchasing power and be worth the same when you withdraw it. But if there is inflation, the value of your money sitting in the bank becomes steadily less valuable, meaning that you have more incentive to spend or invest it.

"A little inflation permits real interest rates to become negative on the rare occasions when required to counter a recession," Ms. Yellen said in 1996. "This could be important."

She, along with her colleagues across the world of central banking, had no idea just how important.

Ms. Yellen's argument — that some inflation would help grease the economy's wheels and give central banks more flexibility to respond to a downturn — prevailed, in the sense that 2 percent became the widespread target of global central banks.

But even as that target was embraced, signs started to emerge that it wasn't high enough to

avoid the kinds of problems that Ms. Yellen and others had described.

Starting in the late 1990s, Japan found itself stuck in a pattern of falling prices, or deflation, even after it cut interest rates all the way to zero. The United States suffered a mild recession in 2001, and the Fed cut interest rates to 1 percent to help spur a recovery. Then came the global financial crisis of 2007 to 2009, spurring a steep downturn across the planet and causing central banks to slash interest rates.

All of this has quite a few smart economists wondering whether the central bankers got the target number wrong. If they had set it a bit higher, perhaps at 3 or 4 percent, they might have been better able to combat the Great Recession because they could cut inflation-adjusted interest rates by more.

“Should policy makers therefore aim for a higher target inflation rate in normal times, in order to increase the room for monetary policy to react to such shocks?” asked Olivier Blanchard, the chief economist of the International Monetary Fund, in a 2010 paper with two co-authors. “To be concrete, are the net costs of inflation much higher at, say, 4 percent than at 2 percent, the current target range?”

Mr. Blanchard offered no definitive answer, but others are more confident that 2 percent inflation has proved misguided.

“It’s kind of a historical accident that we have a 2 percent target to begin with,” said Laurence Ball, an economist at Johns Hopkins University who advocates raising the target to 4 percent. “Any adverse effects on the economy of having 4 percent rather than 2 percent inflation are trivial compared to the effects of having a horrible recession like we’ve been experiencing.”

Such a shift would come at a cost. At 2 percent inflation, it is easy to enter into many financial transactions without really having to adjust for inflation. At 2 percent inflation, the value of a dollar falls by half over 35 years, whereas at 4 percent it falls in half every 18 years. On the other hand, inflation also hovered in the range of 3 to 4 percent through the mid-1980s, hardly remembered as an economic nightmare.

A shift in the target, furthermore, could well cause disruptions in financial markets and potentially a sharp, sudden rise in longer-term interest rates that could slow growth.

Current central bankers view the cost of raising the target as too high to pay. The Fed’s vice chairman, Stanley Fischer, reasserted his support of a 2 percent target earlier this month. And Ms. Yellen has given no indication that she wishes to rethink the target.

Alan Blinder, the Princeton economist and a former vice chairman of the Fed, saw it this way: “Central bankers have invested a lot and established a great deal of credibility on their 2 percent inflation target, and I think they’re right to be very hesitant to give it up. If you change from 2 percent to 3 percent, how does the market know you won’t change 3 to 4?”

But that doesn’t mean you wouldn’t do something different, Mr. Blinder argued, if you could rerun the history of the last 25 years, from New Zealand’s unusual experiment to the present, all while knowing what you know now.

“Probably in the abstract had they settled on a somewhat bigger number, that would have been a better choice,” Mr. Blinder said. “To many academics that means that was a mistake so let’s undo it and do it right. In the practical policy world that’s not always right.”