



## 2%: A Magic Number or an Obsession?

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Inflation Targeting (IT) was first adopted in New Zealand in 1990 with a primary goal of price stability. They were going through years of high inflation and slow growth. Initially, they set a target of between 0 to 2 percent. In 1991, the Inflation rate was down to 2.60% from 6.10%. *Although there is a cost of disinflation and the Real GDP fell, it recovered.* As of August 2019, there are about 71 Central Banks which has adopted an IT Monetary Policy. It can be seen that the authorities are most likely to adopt this policy when their inflation rate is high – to bring it down. Argentina adopted IT in 2016 while the inflation rate was 35.5%, Uganda in 2011 with an inflation rate between 16%-17 %.



The anchor that the policymakers use to control the price levels in an economy evolved from currency peg to floating exchange rate to inflation targeting. IT gets an edge over the other monetary policy frameworks as its easy to communicate the target and be understood by the public. It puts the Central Bank in the limelight, making them more accountable which results in an increased public confidence. Over the last 3 decades, IT has helped economies control extreme volatility of inflation and large price fluctuations for oil & commodities.

### How does it work?

The Central Bank forecasts the inflation rate and compares it with the rate deemed appropriate for the economy by the fiscal policymakers. If the target is not sufficiently credible, the policymakers have the instrument of Interest Rate Policy to adjust the difference. When this forecasted rate is higher than the target, to suppress the growth (*disinflation*), policymakers may increase the nominal interest rate. *One could argue that this could be biased towards one group. The interest income earners get better off at the cost of the lender and vice-versa in a low inflation forecast.* On the contrary, Central Banks are willing to accept a recession (*lower output than natural*) in the short term if they deem the inflation in the economy is above the target. IT is set for a specific timeframe and the Central Banks try to keep the inflation close to this target on average. Meeting this target every quarter isn't feasible and volatility isn't very concerning unless the rates have been consistently over or below the target.

James Bullard, St. Louis Fed explains why setting an inflation target is important as "Firms and households take into account the expected rate of inflation when making economic decisions, such as wage contract negotiations or firms' pricing decisions. All of these decisions, in turn,

feed into the actual rate of increase in prices". Hence, there should be transparency in informing the IT to the market and there should be credibility in maintaining it over the time horizon – to help make businesses and households planning more conducive.

### **The 2% standard**

Most countries have a low single-digit IT. A target of 2% is seen as an ideal rate for price stability. It should mean that the price level should double in about 36-37 years. When true price stability is the target, ideally the rate should be 0, but Reifschneider and Williams in their paper on setting inflation target provides support for what should be a 1% cushion in a very low inflation environments, and 1% is generally added as a measurement error. 2% sort of became an international standard from the '90s since the Fed began planning around it. The US has been averaging a 2% since 1995, but only announced this as a target in 2012. European Central Bank targets a below or close to 2% over the medium term. Bank Of England has historically kept the rate at 2%.

Most economies target a positive IT and not zero or minus as a positive IT drives individuals and businesses to make advance purchases, and should hence boost output and economic growth. Also, a higher inflation rate would mean higher interest rates. This gives Central Banks enough room to cut rates upon recession (*contraction in output for 2 consecutive quarters or more*). While a low-interest rate is expected to result in increased borrowing and spending, hence boost economic growth, the Neo-Fisherian theory suggests that a low Monetary Policy Rate could result in low inflation, as the inflation expectation would fall once the interest rate is set low. Also, when there is a suppressed interest rate the low performing or barely profitable businesses get access to cheap capital and this doesn't always result in better growth, rather an opposite effect leading to potential bad loans, symptoms of an impending debt crisis.

Another reason often cited is to avoid deflation. When deflation happens, the asset prices decline - which may be followed by a debt crisis. Furthermore, there will be a delay in consumption and investment as people forecasts further price falls. The cost of a negative movement of prices in an economy would be far higher than the cost of positive movement.

### **Shortcomings of a low target rate**

It is widely known that the 2% target the economies around the world sees as the magic number has no theoretical justification. Although there is no one size fits for all, the 2% is highly debatable for some of the economies considering how there is little room for rate cuts during a recession since nominal interest rates shouldn't ideally be zero. With a low interest rate, increased money supply should ideally generate inflation as more money is chasing the same quantity of goods, but once the nominal interest rate hits zero the opportunity cost of holding cash is also zero and the increased money supply in the economy translates to more savings and not spending. When the inflation is maintained very low or between 0 to 2, there's a risk of falling into the negatives (*deflation*). The case for a higher IT is that it allows further decreases in interest rates until zero. A higher target could have prevented interest rates from hitting the zeros during the Great Recession. And could prevent the same in the future recessions.

### **Alternative**

According to the IMF, a global recessions may occur over a cycle which lasts between 8 to 10 years. To create enough room for interest cuts during that recession, the IT could be raised to a 3% or even a 4%. There are obviously costs, but not as much as one would incur in lost output

and employment if the rates has to go to zero. If the calculation is wrong, the economy could end up with a marginally higher inflation, but if proved right, the economy is left with enough cushion to respond to the recession.

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