Policy Makers Rethink a 2% Inflation Target

Big debate now for central bankers is what would be a better target

10 COMMENTS *By Tom Fairless*

What's so special about 2% inflation?

From Ottawa to Oslo, policy makers have been considering whether that level of consumer-price growth, a Holy Grail for the world's major central banks over the past quarter-century, is still relevant.

The 2% target was always an arbitrary figure, some economists argue, and even if it was optimal two decades ago, that is no longer the case given deep changes that have since reshaped the global economy.

Trouble is, it isn't clear what inflation rate would be better. Dozens of academic studies that considered that question have produced answers ranging from 6% to less than zero, according to a survey published last year by Federal Reserve economist Anthony M. Diercks. While deflation, or steadily falling prices, are generally considered to weigh on economic growth, a mildly negative inflation rate would also have benefits, such as eliminating the cost of holding cash.

The debate has gained traction since former Federal Reserve Chairwoman Janet Yellen suggested last year that the U.S. central bank might revisit its 2% inflation target. Canadian officials have also suggested they might be open to changing the Bank of Canada's 2% target when its mandate comes up for review in 2021.

Recently, economists have tended to call for a higher target. The main argument: That would give central banks more room to fight economic downturns because higher inflation implies higher interest rates, thus giving the Fed more room to cut.

"Whatever [inflation] rate was thought to be optimal in 2006 or before is now too low," says Olivier Blanchard, a senior fellow at the Peterson Institute for International Economics in Washington, D.C., who has called for a 4% target.

Factors such as aging populations, low economic growth and higher savings rates are working to push down the neutral interest rate, at which the economy is growing at a sustainable rate for the long run and inflation is stable. As a result, central banks run a greater risk of taking benchmark interest rates to zero or below when seeking to support growth.

And yet, Norway's government said recently it would reduce its central bank's inflation target, to 2% from 2.5%, arguing there was no longer any reason to diverge from international norms. With inflation near target, the central bank raised interest rates to 0.75% on Sept. 20.

The case for a higher target runs like this: Policy makers find it difficult to cut benchmark interest rates much below zero. If inflation is 2%, that means central banks can reduce the real interest rate—the benchmark rate minus inflation—to minus 2% by cutting the benchmark rate to zero. If inflation were higher, say 4%, cutting the benchmark rate to zero would push the inflation-adjusted rate to minus 4%, providing an extra kick for the economy.

Higher inflation could have other benefits. It could help economies adjust after a downturn by lessening the need for outright wage cuts, because rising prices will erode wages anyway. It could also make it easier for borrowers to pay down debt, though that is something that lenders historically have always resisted. A 2009 study estimated that U.S. inflation of 6% for four years could reduce the nation's debt-to-GDP ratio by around 20 percentage points, similar to what happened after World War II.

Other economists have cast doubt on whether that level of inflation would reduce the debt ratio by so much. And many worry that central banks would struggle to push inflation to 6% anytime soon, given how hard it was to hit 2%.

Vítor Constâncio, the European Central Bank's vice president back in May, said at the time that while he had "no theoretical objections" to a "mild" upward revision of the inflation target, moving to a new target could undermine central banks' hard-won credibility.

The ECB is among a group of central banks that have reduced benchmark interest rates below zero, a novel move aimed at providing extra stimulus to their economies. Former Fed Chair Ben Bernanke has suggested that negative rates might be a better alternative to higher inflation targets.

"Yes, negative interest rates raise a variety of practical problems, as well as political and communications issues, but so does a higher inflation target," Mr. Bernanke wrote in a 2016 blog post. "In the political sphere, the fact that negative rates would be temporary and deployed only during severely adverse economic conditions would be an advantage."

Higher inflation can have drawbacks, as many economies have learned through painful experience. It could distort the tax system and mask economic signals, such as whether goods are rising in price because they are scarce. Banks might demand an inflation-risk premium when granting long-term loans, because high inflation can lead to more volatile price movements, says Michael Schubert, an economist with Commerzbank in Frankfurt. Thus, financing would become more expensive, causing companies to invest less.

Crucially, an inflation rate of 2% allows households and businesses to largely disregard price increases. That effect might be lost if inflation is allowed to rise much higher.

"We know that some number higher than a 2% to 3% rate of inflation will materially enter decision-making, because we have had plenty of experience of higher rates of inflation that demonstrates that," says Guy Debelle, deputy governor of Australia's central bank. "How much higher though, we don't really exactly know."

One possible solution: Central banks could allow inflation to rise a bit above 2% without aggressively trying to bring it down. That could give them more room for maneuver, and gradually inflate away some of the world's enormous debt load.

It seems to already be happening in the U.S., where inflation in August was 2.7%. The Fed has been raising rates, but only gradually, and doesn't seem likely to step up its pace.

Although eurozone inflation has accelerated in recent months and is now 2%, the ECB has signaled that it won't raise rates for about a year.

Joseph Gagnon, a fellow at the Peterson Institute, says the Fed "ought to tilt policy toward overshooting, not for its own sake, but to avoid" undershooting its target again in future.

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