

Why two percent?

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Abstract

Where inflation targeting came from, why the target is positive rather than zero, and the argument for raising it.

Almost every advanced-economy central bank aims at inflation of about 2 percent a year. The number looks arbitrary, and in part it is: it was chosen in New Zealand in 1989–1990 as a range that seemed low enough to count as price stability and high enough to be achievable, and other central banks copied it because it worked. But there are reasons a small positive number beats zero, and there is a live argument that it should be higher.

The origin

The Reserve Bank of New Zealand Act of 1989 made price stability the bank’s sole statutory objective and required the governor and the finance minister to agree a numerical target in a public document (New Zealand Parliament, 1989). Canada followed in 1991, the United Kingdom in 1992, Sweden in 1993. Bernanke, Laubach, Mishkin and Posen described the framework as it stood at the end of the decade and gave it its standard definition: a public numerical target, a commitment to price stability as the primary goal, transparency about the outlook and decisions, and accountability for outcomes (Bernanke et al., 1999). The Federal Reserve adopted an explicit 2 percent objective only in January 2012; the ECB defined price stability numerically from 1998 and clarified it as symmetric 2 percent in 2021 (European Central Bank, 2021).

Definition 1 (Inflation targeting). A monetary policy framework with (1) a public numerical inflation objective, (2) price stability as the primary goal, (3) decisions explained in terms of the inflation forecast, and (4) accountability for missing the target. The instrument is not fixed by the framework; the goal is.

Why not zero?

Three arguments explain why the number is positive.

Measurement bias. Consumer price indices overstate inflation because they capture quality improvements and substitution imperfectly. The Boskin Commission put the bias in the US CPI at about 1.1 percentage points a year in the mid-1990s (Boskin et al., 1996); later methodological changes reduced it, but a measured 2 percent still corresponds to a smaller true rise in the cost of living.

Downward nominal wage rigidity. Workers resist cuts in nominal wages more than they resist real wage erosion through inflation. Akerlof, Dickens and Perry argued that at zero inflation firms cannot lower real wages where they need to, so unemployment is permanently higher; a little inflation “greases the wheels” (Akerlof et al., 1996).

Room above the lower bound. The neutral nominal rate is $r^* + \pi^*$. With a higher target the central bank has more room to cut before hitting the bound described in The effective lower bound. This argument grew in weight as r^* fell.

The case for four

Blanchard, Dell’Ariccia and Mauro asked after 2008 whether 2 percent had been a mistake: with a 4 percent target, central banks would have had two more points to cut in 2008–2009 (Blanchard et al., 2010). Ball made the case in full, arguing that the costs of 4 percent inflation are small and the benefit of avoiding the bound is large (Ball, 2014). The counter-arguments are that the transition would cost credibility, that the costs of inflation are nonlinear in ways the models miss, and that the tools of Forward guidance and asset purchases substitute for the missing rate cuts. No major central bank changed its number; the debate resurfaced in 2022, when raising the target looked like an excuse for missing it.

What the number does

The target is less important as a number than as an *anchor*, the subject of Anchored expectations. A central bank that is believed to deliver 2 percent has households and firms setting prices and wages on that assumption, which makes 2 percent easier to deliver. The framework’s value is in that loop, and the loop is the reason central banks are reluctant to touch the number even when the arguments for a change are decent.

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