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What's Wrong With the 2 Percent Inflation Target: Paul Volcker

False precision can lead to dangerous policies.

By Paul Volcker

(Bloomberg Opinion) -- In 1996, Federal Reserve Chairman Alan Greenspan had an exchange with Janet Yellen, then a member of the Fed's Board of Governors, that presaged a major – and, I think, ill-advised – change in the central bank's approach to managing the economy.

Yellen asked Greenspan: "How do you define price stability?" He gave what I see as the only sensible answer: "That state in which expected changes in the general price level do not effectively alter business or household decisions." Yellen persisted: "Could you please put a number on that?"

Since then, under the chairmanship of Ben Bernanke and then under Yellen, Alan's general principle – to me entirely appropriate – has been translated into a number: 2 percent. And more recently, a remarkable consensus has developed among central bankers that there's a new "red line" for policy: A 2 percent rate of increase in some carefully designed consumer price index is acceptable, even desirable, and at the same time provides a limit.

I puzzle about the rationale. A 2 percent target, or limit, was not in my textbooks years ago. I know of no theoretical justification. It's difficult to be both a target and a limit at the same time. And a 2 percent inflation rate, successfully maintained, would mean the price level doubles in little more than a generation.

I do know some practical facts. No price index can capture, down to a tenth or a quarter of a percent, the real change in consumer prices. The variety of goods and services, the shifts in demand, the subtle changes in pricing and quality are too complex to calculate precisely from month to month or year to year. Moreover, as an economy grows or slows, there is a tendency for prices to change, a little more up in periods of economic expansion, maybe a little down as the economy slows or recedes, but not sideways year after year.

Yet, as I write, with economic growth rising and the unemployment rate near historic lows, concerns are being voiced that consumer prices are growing too slowly – just because they're a quarter percent or so below the 2 percent target! Could that be a signal to "ease" monetary policy, or at least to delay restraint, even with the economy at full employment?

Certainly, that would be nonsense. How did central bankers fall into the trap of assigning such weight to tiny changes in a single statistic, with all of its inherent weakness?

I think I know the origin. It's not a matter of theory or of deep empirical studies. Just a very practical decision in a far-away place.

New Zealand is a small country, known among other things for excellent trout fishing. So, as I left the Federal Reserve in 1987, I happily accepted an invitation to visit. It turns out I was there, in one respect, under false pretenses. Getting off the plane in Auckland, I learned the fishing season was closed. I could have left my fly rods at home.

In other respects, the visit was fascinating. New Zealand economic policy was undergoing radical change. Years of high inflation, slow growth, and increasing foreign debt culminated in a sharp swing toward support for free markets and a strong attack on inflation led by the traditionally left-wing Labour Party.

The changes included narrowing the central bank's focus to a single goal: bringing the inflation rate down to a predetermined target. The new government set an annual inflation rate of zero to 2 percent as the central bank's key objective. The simplicity of the target was seen as part of its appeal – no excuses, no hedging about, one policy, one instrument. Within a year or so the inflation rate fell to about 2 percent.

The central bank head, Donald Brash, became a kind of traveling salesman. He had a lot of customers. After all, those regression models calculated by staff trained in econometrics have to be fed numbers, not principles.

I understand reasonable arguments can be made for 2 percent as an upper limit for "stability." There is a body of analysis that suggests official price indexes typically overstate increases by failing to

account for improvements in the quality of goods and services over time. The point is also made that expectations and behavior are determined by the price of goods, where productivity gains and strong competition restrain price increases, rather than by the cost of services like education and medical care, where productivity gains are slow.

But it is also true, and herein lies the danger, that such seeming numerical precision suggests it is possible to fine-tune policy with more flexible targeting as conditions change. Perhaps an increase to 3 percent to provide a slight stimulus if the economy seems too sluggish? And, if 3 percent isn't enough, why not 4 percent?

I'm not making this up. I read such ideas voiced occasionally by Fed officials or economists at the International Monetary Fund, and more frequently from economics professors. In Japan, it seems to be the new gospel. I have yet to hear, in the midst of a strong economy, that maybe the inflation target should be reduced!

The fact is, even if it would be desirable, the tools of monetary and fiscal policy simply don't permit that degree of precision. Yielding to the temptation to "test the waters" can only undercut the commitment to stability that sound monetary policy requires.

The old belief that a little inflation is a good thing for employment, preached long ago by some of my own Harvard professors, lingers on even though Nobel Prize–winning research and experience over decades suggests otherwise. In its new, more sophisticated form it seems to be fear of deflation that drives the argument.

Deflation, defined as a significant decline in prices, is indeed a serious matter if extended over time. It has not been a reality in this country for more than eighty years.

It is true that interest rates can't fall significantly below zero in nominal terms. So, the argument runs, let's keep "a little inflation" – even in a recession – as a kind of safeguard, a backdoor way of keeping "real" interest rates negative. Consumers will then have an incentive to buy today what might cost more tomorrow; borrowers will be enticed to borrow at zero or low interest rates, to invest before prices rise further.

All these arguments seem to me to have little empirical support. Yet fear of deflation seems to have become common among officials and commentators alike. (Even back in July 1984, as my Fed colleagues and I were still monitoring the 4 percent inflation rate, the New York Times had a front-page story warning about potential deflation.) Actual deflation is rare. Yet that fear can, in fact, easily lead to policies that inadvertently increase the risk.

History tells the story. In the U.S., we have had decades of good growth without inflation – in the 1950s and early 1960s, and again in the 1990s through the early 2000s. Those years of stability were also marked by eight recessions, mostly quick, that posed no risk of deflation.

Only once in the past century, in the 1930s, have we had deflation, serious deflation. In 2008–2009 there was cause for concern. The common characteristic of those two incidents was collapse of the financial system.

We can't expect to prevent all financial excesses and recessions in the future. That is the pattern of history with free markets, financial innovation, and our innate "animal spirits."

The lesson, to me, is crystal clear. Deflation is a threat posed by a critical breakdown of the financial system. Slow growth and recurrent recessions without systemic financial disturbances, even the big recessions of 1975 and 1982, have not posed such a risk.

The real danger comes from encouraging or inadvertently tolerating rising inflation and its close cousin of extreme speculation and risk taking, in effect standing by while bubbles and excesses threaten financial markets. Ironically, the "easy money," striving for a "little inflation" as a means of forestalling deflation, could, in the end, be what brings it about.

That is the basic lesson for monetary policy. It demands emphasis on price stability and prudent oversight of the financial system. Both of those requirements inexorably lead to the responsibilities of a central bank.

(This is an edited excerpt from the upcoming book "Keeping At It: The Quest for Sound Money and Good Government," by Paul Volcker with Christine Harper.)

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