

# The Economist explains: Why the Fed targets 2% inflation

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*The Economist*

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# The Fed targets 2% inflation

- The 2% target that is the lodestar of Fed policy
- Why?

- Monetary policy: roughly speaking, the job of controlling the amount of money that courses through the economy.
- For a long time, monetary policy consisted of little more than stabilisation of the exchange rate, which was often fixed (eg by the gold standard at the beginning of the 20th century) in order to facilitate international commerce

## Exchange rates: A poor target

- But exchange rates proved a poor target for policymakers.
- Pulling money out of the economy to buoy the currency and protect the exchange rate could send the economy into a tailspin; such policies helped create the Depression of the 1930s.

- After the Depression governments prioritised domestic employment.
- Central banks reckoned the economy followed a relationship known as the Phillips curve, which posits a trade-off between inflation and unemployment

# Stagflation

- Yet amid the "stagflation" of the 1970s, an unholy mixture of economic stagnation with inflation, economists realised that this relationship weakened over time
- Economists realised the best a central bank could do to boost long-run growth was to make the path of policy clear and predictable to the public.

## A target

- Central banks needed to select an economic variable to set as a target: one linked to the health of the economy and over which the central bank could exercise some control.
- Milton Friedman reckoned central banks should aim for growth in the money supply.
- Central banks tried that for a while, but found that when they made money growth their target the relationship between it and the health of the economy broke down, just as the Phillips curve had

# A inflation target

- Many then settled on an inflation target
- Inflation was readily observable and, it was thought, was a reliable thermostat for an economy.
- Eventually most central banks chose 2% as target
- It appears that central banks may need to change their targets once again, and soon