Beyond 2%: Rethinking Inflation Targeting in a Post-Pandemic Economy

A Comparative Analysis of Nominal GDP Targeting, Monetarism, and Average Inflation Targeting in Light of Empirical Evidence and Sovereign Debt Dynamics

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Introduction:

Since its formal adoption by the U.S. Federal Reserve in 2012, the 2% inflation target has become a cornerstone of monetary policy, symbolizing a balance between price stability and economic growth. However, the post-2008 low-inflation environment, the COVID-19 pandemic, and recent inflation surges have prompted economists and policymakers to revisit and critique the rigidity of this benchmark. In response, alternative frameworks such as **Nominal GDP Targeting (NGDPT)**, **Monetarism**, and **Average Inflation Targeting (AIT)** have gained renewed attention.

Each paradigm offers distinct theoretical justifications, empirical track records, and policy implications, particularly concerning sovereign debt sustainability, macroeconomic stability, and central bank credibility. While NGDPT promises countercyclical flexibility, monetarism emphasizes monetary discipline, and AIT seeks to average out inflation fluctuations over time. These frameworks also carry different consequences for government debt servicing and fiscal-monetary interactions, especially in periods of economic stress.

This article critically examines these alternatives, using historical case studies, theoretical models, and empirical evidence to assess their viability in an era of fiscal expansion, climate risk, and supply chain volatility. By analyzing their potential to replace or complement the 2% target, we explore whether the time has come for a more adaptive and resilient approach to inflation targeting.

1. Nominal GDP Targeting (NGDPT)

Theoretical Foundation
Nominal GDP targeting (NGDPT) aims to stabilize the path of nominal economic output, which is

the sum of real GDP growth and inflation. Proponents argue that NGDPT offers a more robust framework for managing supply shocks than strict inflation targeting, as it allows inflation to rise temporarily in response to negative supply-side disturbances while preserving output (Sumner, 2011). By responding to both inflation and real activity, NGDPT better aligns with the dual mandate of many central banks, namely, price stability and maximum employment.

Empirical Case

Beckworth and Hendrickson (2019) simulated the U.S. economy under a hypothetical NGDP target during the Great Recession and found that it would have produced more stable macroeconomic outcomes. Specifically, an NGDP rule would have prompted earlier and more aggressive monetary easing in 2008–2009, potentially mitigating the sharp declines in output and employment. The framework encourages central banks to "make up" for past shortfalls in nominal spending, thus avoiding prolonged recessions and deflationary spirals.

Global Consideration

While no major central bank has formally adopted NGDP targeting, interest in the approach has been evident in several advanced economies. The United Kingdom and Canada have studied the viability of NGDPT, and the Reserve Bank of New Zealand evaluated it during its monetary policy framework reviews (Ng, 2021). Academic support for NGDPT has grown in light of persistent inflation volatility and questions about the efficacy of conventional inflation targeting during low-rate environments.

Policy Implications

NGDP targeting holds several important implications for fiscal and monetary policymaking. First, by stabilizing the growth path of nominal income, NGDPT could improve sovereign debt sustainability. Since public debt is typically denominated in nominal terms, a stable and predictable path of nominal GDP ensures more reliable revenue generation and reduces the likelihood of adverse debt dynamics during economic downturns (Woodford, 2003). Second, NGDPT may enhance macroeconomic stability by reducing the frequency and severity of recessions, especially when compared to inflation-targeting regimes that may inadvertently tighten policy during supply shocks (Sheedy, 2014). Lastly, the credibility of central banks could be strengthened or weakened depending on communication effectiveness. While NGDPT offers a clearer long-run nominal anchor, it requires substantial public and market understanding, as the concept of targeting a nominal aggregate may be less intuitive than targeting inflation alone (Frankel, 2012).

2. Monetarism

Theoretical Foundation

Monetarism, most closely associated with Milton Friedman, asserts that "inflation is always and everywhere a monetary phenomenon" (Friedman, 1968, p. 39). The core policy prescription is that central banks should target a stable and predictable rate of money supply growth, roughly in line

with long-term potential output. This rule-based approach is designed to eliminate discretionary monetary shocks and anchor inflation expectations over time.

Historical Examples

- **United States (1979–1982):** Under Federal Reserve Chair Paul Volcker, the Fed adopted a monetarist framework by targeting monetary aggregates (such as M1 and M2) to control inflation. This strategy contributed to reducing inflation from nearly 14% in 1980 to below 5% by 1982. However, it came at the cost of a severe recession, with unemployment exceeding 10% (Mishkin, 2007).

- **United Kingdom (1980s):** The Thatcher government similarly implemented monetarist policies focused on controlling M3. While inflation declined, the policies also led to high interest rates and mass unemployment, sparking criticism and ultimately prompting a gradual shift away from strict monetary targeting (Goodhart, 1989).

Criticisms

The empirical failure of monetarism stemmed largely from instability in money demand functions. Rapid financial innovation and deregulation in the 1980s made monetary aggregates harder to control and less reliable as guides for policy. As a result, central banks including the Fed and the Bank of England gradually abandoned strict monetarist regimes by the late 1980s (Mishkin, 2007).

Policy Implications

While monetarism had mixed results in practice, it remains relevant in theoretical debates over sovereign debt sustainability, macroeconomic discipline, and central bank credibility.

From a fiscal perspective, monetarist discipline, through strict control of money growth, limits the temptation to finance public deficits through monetary expansion, thereby reducing inflationary pressures and supporting sovereign debt sustainability (Sargent & Wallace, 1981). Historical episodes, such as the U.S. in the early 1980s, show that a credible commitment to disinflation, even at the cost of short-term output losses, can restore investor confidence and lower long-term borrowing costs.

In terms of macroeconomic stability, monetarist policies can be stabilizing in economies where inflation expectations are poorly anchored, or where discretionary policy is subject to political interference. However, the rigidity of monetarist rules can also be a liability during economic shocks, as it constrains the central bank's ability to respond flexibly.

Finally, central bank credibility may benefit from the perception of rule-based, non-discretionary policy frameworks. Yet, as experience showed, the inability to accurately predict money demand reduced the transparency and effectiveness of monetarist regimes, ultimately undermining credibility (Goodhart, 1989). This historical evolution influenced the transition toward inflation targeting and, more recently, average inflation targeting and nominal GDP targeting.

3. Average Inflation Targeting (AIT)

Theoretical Basis

Average inflation targeting (AIT) is a refinement of traditional inflation targeting. Rather than aiming to keep inflation at a constant rate (e.g., 2%), AIT seeks to stabilize inflation *around* an average overtime. This allows the central bank to tolerate temporary deviations, particularly undershoots, so that the longer-run average remains anchored at the target. This approach enhances the credibility of commitments to long-run price stability and helps stabilize inflation expectations, particularly when nominal interest rates are constrained by the effective lower bound (Bernanke et al., 2019).

Implementation Example: U.S. Federal Reserve (2020)

In August 2020, the Federal Reserve formally adopted AIT as part of its revised monetary policy strategy. The move was driven by a decade of inflation running persistently below the 2% target, undermining expectations and weakening monetary transmission. Under AIT, the Fed committed to aiming for inflation that "averages 2 percent over time," implying it would allow overshoots following periods of undershoot (Federal Reserve, 2020; Powell, 2020).

Empirical Review

The AIT framework was tested in real time following the COVID-19 pandemic. While it initially helped justify accommodative policy in the face of economic slack, critics argue that the Fed's tolerance for overshooting led to delayed tightening in 2021. Inflation spiked to over 7% in 2022, contributing to real wage erosion and loss of purchasing power for households (Smialek, 2022). Although proponents argue that the underlying framework was sound, its credibility suffered due to weak communication and lack of a clearly defined time horizon for averaging (Clarida, 2022).

Policy Implications

- **Sovereign Debt Sustainability**
  AIT has both supportive and cautionary implications for sovereign debt management. By allowing temporary inflation overshoots, AIT may reduce the real burden of public debt through inflation erosion, particularly beneficial when debt levels are elevated. However, if inflation expectations become unanchored, rising nominal interest rates may increase debt servicing costs over time. For instance, U.S. federal interest payments surged after 2022 due to higher policy rates, challenging fiscal sustainability (CBO, 2023). Thus, effective AIT implementation requires a delicate balance between flexibility and long-term credibility.

- **Macroeconomic Stability**
  AIT's flexibility allows central banks to better manage real economic fluctuations, particularly in environments prone to persistent disinflation and demand shortfalls. By committing to make up for past inflation misses, AIT can reinforce monetary accommodation when interest rates are near zero, enhancing stability during downturns (Bernanke et al., 2019). However, if not clearly communicated or if average periods are ambiguous, it may increase uncertainty and destabilize expectations during supply shocks, as seen in 2021–2022.

- **Central Bank Credibility**
  Credibility is a cornerstone of successful AIT. If households and markets trust that the central bank will deliver an average inflation rate of 2% over time, inflation expectations become more stable, reinforcing policy effectiveness. However, the Fed's handling of AIT during the post-pandemic recovery has been viewed by some analysts as weakening credibility, particularly given the lag in tightening policy despite clear inflation signals (Clarida, 2022). Therefore, maintaining a transparent communication strategy and setting clear temporal benchmarks for averaging are essential to sustaining trust in AIT regimes.

To better understand the trade-offs between various monetary policy frameworks, **Table 1** offers a comparative overview of Nominal GDP (NGDP) targeting, Monetarism, and Average Inflation Targeting (AIT). Each framework presents distinct advantages and challenges. NGDP targeting provides a balanced approach by integrating both inflation and real output objectives, though its practical adoption has been limited and communication can be complex. Monetarism offers clarity through rule-based discipline but has struggled with the instability of money demand, particularly since the 1980s. AIT, which the Federal Reserve formally adopted in 2020, aims to anchor long-term expectations by allowing temporary overshooting of the inflation target, yet it carries the risk of short-run volatility and misperceptions among the public. These comparisons highlight the importance of institutional credibility, transparency, and economic context in determining the optimal inflation targeting strategy.

Table 1
Comparison of Inflation Targeting Frameworks and Their Key Trade-Offs

Framework	Key Advantage	Major Challenge
NGDP Targeting	Balances output and inflation; flexible	No real-world adoption yet; communication issues
Monetarism	Clear rule-based discipline	Breakdown of money demand stability
Average Inflation Targeting (AIT)	Anchors expectations over time	Risk of unanchored inflation in the short run

Note. NGDP = Nominal Gross Domestic Product; AIT = Average Inflation Targeting. This table compares major inflation targeting frameworks based on theoretical advantages and practical limitations.

Conclusion

Each alternative framework, NGDPT, monetarism, and AIT, offers different strengths. NGDPT presents a compelling, empirically supported, and theoretically balanced approach, though it lacks real-world adoption. Monetarism's rigid focus on money supply proved unsustainable due to real-

world complexities. AIT, currently in use by the Fed, holds promise but requires careful calibration and stronger communication mechanisms.

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