The ideological origins of some numbers in economics

An inflation target of 2 per cent, a fiscal deficit target of 3 per cent and a public debt to GDP ratio of 60 per cent were all numbers plucked out of thin air

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I am not sure if the numbers two, three and sixty would have fascinated the great mathematician Ramanujan but they certainly meant a lot to economists, particularly since the rise of the neoliberal era in the last quarter of the twentieth century. The number two or 2% became synonymous with an inflation target, 3% with the fiscal deficit target and 60% as the upper limit in the ratio of public debt to gross domestic product (GDP). In doing so, these target numbers, whether or not they were achieved, encaged macroeconomics and macroeconomic thought for decades.

The early 1960s were probably the best years in modern US economic history, with declining unemployment rates and inflation stable at less than 2%. Although unemployment continued to decline until 1970, inflation gradually began to rear its head from 1965, crossing 5% in 1970, but then declining to just over 3% in 1972. Nonetheless, the trend in rising inflation enabled economists like Milton Friedman to launch an attack on the welfare state based on Keynesian policies but more importantly to check the growing share of labour in US GDP. Then came the oil shock of 1973, triggered by the Yom Kippur war between Israel and Egypt that pushed US crude oil prices per barrel from $3.60 in 1972 to $12.21 in 1975 and $37.42 by 1980. Inflation rates skyrocketed from 3.2% in 1972 to 13.5% in 1980. Although the reason for high inflation and rising unemployment clearly lay in high oil prices – or what is referred to as cost-push factors – the opportunity was seized by economists to dismantle the post-war Keynesian edifice by arguing that government spending or demand-pull factors would only exacerbate inflation without solving the unemployment problem in the longer term.

A new economic paradigm took definitive shape soon after Paul Volcker, Chairman of the US Federal Reserve, suppressed inflation by increasing interest rates to record highs of close to 19%, although at the cost of inducing a recession. US GDP growth rate turned negative and unemployment rates reached 11% in 1982. However, with inflation tamed, interest rates could be brought down so that the private sector would be able to propel growth through higher private investment spending. At the same, the push for freer global capital flows and international trade kept US wages in check. Not surprisingly then, by 2010, labour's share in US non-farm business sector had fallen to 56% from a high of more than 66% in 1961.

The neoliberal economic paradigm had arrived, enshrined in the principles of the Washington Consensus, spreading like a prairie fire, and unrooting all other alternative paradigms of development that economists had contemplated. Free market capitalism proffered to take the world from Keynes' 'road to serfdom' and put us on the 'highway to prosperity' if inflation rates were kept low and stable, while at the same time, government expenditure was capped, so that independent central banks were not compelled to raise interest rates to counter the inflationary pressures generated on account of profligate government spending.

Although macroeconomic theory rationalized the ideological faith in free market capitalism, implementation of decisive monetary policy required an anchor in a computable metric. A 2% inflation target was proposed. But where did this magical number come from? Interestingly, neither did it originate from theory nor in a large economy like the US or Japan but rather in the small island-nation with a population of 5 million, New Zealand. A fascinating piece in the New York Times (2014) narrates the sequence of events that culminated in Donald T. Brash, then Governor of the Reserve Bank of New Zealand adopting the number that starkly 'was plucked out of the air'. Even if the number was arbitrary, the effect was indeed magical. Inflation expectations were anchored, resulting in greater confidence and definitiveness over the Central Bank's actions. In a matter of just two years between 1989 and 1991, New Zealand saw its inflation rate falling from almost 8% to 2%. Even as countries across the world set their own targets like 4% (+/- 2%) in India or 6% to 10% in Ghana, there remained a crucial concern. What if the inflation target rate set is too low, constraining the full utilization of resources and not allowing for a higher standard of living?

A few years earlier, on the fiscal front, to check government profligacy, another metric had been introduced: a fiscal deficit target number of 3% of GDP. Its origin was equally stark: in 1982, when the French government faced a problem with rising fiscal deficits, Guy Abeille, an employee in the finance ministry, was asked to suggest a solution to the problem. Given that France's deficit at that time was 2.6% of GDP, he chose the target number as 3% as it would have been difficult to lower the existing deficit. This rule was then incorporated in the Maastricht Treaty and became a rule that member states of the Eurozone had to adhere to. The 60% debt to GDP target was also introduced in the Eurozone and was equally arbitrary rather than being the outcome of any theoretical exercise. While a deficit target may no doubt be important for the introduction of a common currency as in the case of the Eurozone, its acceptance across monetarily sovereign nations that issue their own fiat currencies was the outcome of the overpowering neoliberal macroeconomic worldview.

The change in macroeconomic thinking post the global financial crisis of 2008 and even more so since the breaking out of the Covid-19 pandemic is evident in the veneration to these target numbers, or more precisely, the lack of it thereof. In the US, like in 1970, inflation has recently crossed the 5% mark, deficits touched 15% of GDP in 2020 and debt to GDP stands at 130%. And in spite of these extraordinarily high numbers, US President Biden is pushing for an additional $1.9 trillion stimulus plan. Whatever happened to those once sacred numbers? Recent tweets by Oliver Blanchard, one of the most cited economists, tell us how confused macroeconomists actually are: even as he thinks that Biden's package may be too large, he questions his own opinion, 'Could I be wrong and too pessimistic? Sure.'

The political fallout of neoliberalism with rising unemployment, sometimes camouflaged in declining labour force participation rates, and the extreme skewness in the distribution of income and wealth, has led the political class to side-line economists and instead pursue policies that can prevent further social and economic polarization. In other words, it has now become obvious that the target numbers

– 2%, 3% and 60% – were always ideologically motivated and never based on any objective principles that economists made them seem like, with their mathematically opaque models.

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