Reassessing the Role of Inflation Targeting in the Disinflation of New Zealand and Sweden

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The rapid fall of inflation in New Zealand and Sweden in the late 1980s and early 1990s is often attributed to the implementation of inflation targeting. In both countries, inflation fell from volatile, often-double-digit levels to a relatively stable 2%. However, other developments question the effectiveness of inflation targeting, specifically that inflation continued to fall in these countries after the 1990s, and inflation targeting has had little effect on inflation in most other countries. This paper argues that other structural and institutional changes – and not inflation targeting – brought down inflation in New Zealand and Sweden. Both countries pursued highly inflationary responses to deindustrialization and other structural changes in the 1970s and 1980s. New Zealand protected domestic industry through trade barriers and nationalization, delaying the process of deindustrialization that brought down wage growth and inflation in other countries. Sweden expanded public sector employment in services with stagnant productivity, and at the same time, matched wages to manufacturing where productivity growth was high. The result was growing government budgets, repeated devaluations, and surging inflation. These findings suggest a limited role of inflation targeting for the slowdown of inflation in New Zealand and Sweden, which accords with the limited effect in other countries. The findings also suggest ways that countries could encourage stronger aggregate wage growth and ward off deflation.