

Would a **LITTLE** Inflation Produce a **BIGGER** Recovery?

Why some economists actually want the Fed to push prices higher — and what it might cost the economy

BY RENEE HALTOM

The economic recovery has been disappointing, to say the least. The economy has failed to produce the typical post-recession burst of growth that helps make up for lost output and gets laid-off individuals back to work, leaving production and employment far below trend. More than 13 million Americans remain out of work two and a half years after the recession's end.

These sluggish conditions persist despite the Fed's unusual efforts to speed the recovery. The Fed pushed its interest rates as low as they can go, the so-called zero bound, three years ago. Then the Fed suggested it would keep rates low as far as the eye can see, pumped well over \$1 trillion of liquidity into the economy, and sought to push down longer-term lending rates by "twisting" the yield curve.

Given the Fed's influence over the economy, it is natural to hope the Fed could do still more to nourish the recovery. Some economists have recently offered a proposal that would have been viewed unfavorably just a few decades ago when spiraling prices were wreaking havoc with the economy: purposely generating higher inflation. Everyone knows that low interest rates make borrowing cheaper, but what actually spurs economic activity is the *real* interest rate: the nominal rate minus the expected rate of inflation. When the Fed can't lower nominal rates any further, in theory it can try to create the same effect by raising expected inflation.

While a lively debate on this idea has emerged, the economics profession as a whole is far from sold on the idea in today's context. It is not clear that easier monetary policy — designed to stoke inflation — could improve the current employment slump. The potential costs of higher inflation are more apparent: It could damage the Fed's credibility and make it harder for people to plan for the future, both of which hinder employment and economic growth.

Committing to be Irresponsible

The idea that inflation could be helpful would seem to be an about-face in central banking. The last 30 years of economic research has led economists to generally conclude that fighting inflation should be the central bank's number-one priority. Focusing on price stability turns out to be the most direct way that monetary policy can contribute to the economy's ability to produce jobs, the other side of the Fed's "dual mandate" for monetary policy. Since the early 1980s, the Fed generally has sought to stimulate employment with expansionary policies only when inflation has been in check. The Fed targets inflation that runs 2 percent annually over time, low enough to avoid the major costs of inflation, but comfortably above a state of deflation. For the past

several years, inflation has been coming in near or slightly below that target, though it edged higher in 2011 (see chart).

But some economic models suggest that at the zero bound, inflation can act as a defibrillator to an economy whose growth seems to have flatlined. According to this theory, the central bank needs to create the temporary spike in inflation expectations that pushes real interest rates negative. That's easier said than done. Everyone knows that once the economy starts churning, higher inflation will no longer be what the central bank wants; it has an incentive to renege on the promise once it gets the economic jumpstart it was craving. People can see that coming, so it's not a given that the central bank can raise inflation expectations in the first place. Instead, the central bank must "credibly promise to be irresponsible" in the future, Princeton University economist Paul Krugman wrote in 1998. That is, people must believe it will follow through in inflating tomorrow even if it is no longer optimal at that point.

Some economists have argued that central banks' normal inflation targets are too forgiving to accomplish that. For many central banks, there are no obvious repercussions to missing the inflation target year after year, so an inflation target may not be enough to convince the public that inflation is coming. What the central bank should do is publicly commit to "catching up" on its major inflation misses, argued Gauti Eggertsson at the New York Fed and Michael Woodford of Columbia University in a seminal 2003 paper.

Eggertsson and Woodford show that "price-level targeting" can do the trick. That's when the central bank focuses on the level of average prices rather than its rate of change for a short period of time, just long enough to get the price level back on the path it would have been on without a bad recession. If the average basket of goods costs \$100 in one year, a typical inflation target of 2 percent would see the price grow to \$102 the next year and roughly \$104 the year after that. Under price-level targeting, if inflation comes in too low — say the basket costs only \$101 after the first year — the central bank would create "catch-up" inflation to get the basket to cost \$104 the second year, as targeted. The central bank wouldn't want to fail on that objective for fear of jeopardizing its credibility.

Many economists who want to see the Fed adopt price-level targeting today point out that Fed Chairman Ben Bernanke was once on board with the idea: In 2003, he advised Japan, then in the throes of its "lost decade" of economic stagnation, to adopt the strategy. Japan's main problem, however, was deflation, a problem that the United States does not currently have. In a deflationary economy,

nominal interest rates could be at rock bottom, but if prices are expected to fall, then the real interest rate is actually *higher* (because low nominal rates minus a negative inflation rate equals higher real interest rates). That encourages saving and discourages borrowing and investment, a situation some economists call a “liquidity trap.”

We are not in a deflationary quagmire today, but what we have in common with Japan circa 2003 is an anemic recovery in most forecasts. That leaves the economy producing only slow improvements in unemployment for the foreseeable future. The appealing aspect of price-level targeting is that it could, in theory, help speed growth to close that gap.

Would Inflation Bring Jobs?

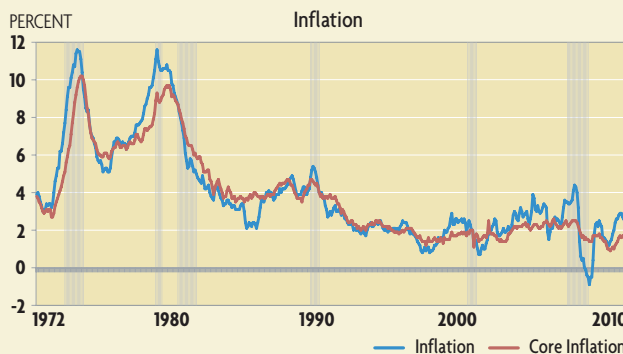
It’s not a given that catch-up inflation would translate to catch-up employment, however. That depends on why the labor market has remained so weak — one of the top questions dividing economists today.

There are reasons to believe that the economy’s ability to produce jobs has deteriorated, such that the economy is not operating as far below its potential as people might think. The economy is producing fewer jobs for the same amount of output: Firms have learned to produce with fewer employees, and temporary workers have been tapped as a lower-risk option for employers in an uncertain economy. The “long-term unemployed” — there are 5.6 million of them, more than two-fifths of the total pool of unemployed people — find it harder to get a job the longer they are out of the workforce. This might be because their skills erode, they are perceived as less valuable, or they lose the networks that might otherwise help them find new jobs. Another explanation is that people who are likely to become long-term unemployed are individuals who had lower chances of finding a job in the first place, a point argued by Andreas Hornstein and Thomas Lubik in an essay appearing in the Richmond Fed’s 2010 *Annual Report*. Many economists and business leaders also argue that a “skill mismatch” was left behind by downsizing industries such as construction and real estate. Thousands of people compete for lower-skilled job offerings, while “[i]f we set up a new site to hire 100 software or storage or networking engineers, we have to go find them one at a time and seek them out and convince them and cajole them to work for us,” Dell Chairman and CEO Michael Dell told *Fortune* magazine in October 2011.

Even if inflation could temporarily jolt aggregate demand, it can’t retrain workers, change production technology, or match people to the right jobs. It also can’t reduce uncertainty caused by fiscal and regulatory policies that may be holding back hiring: For example, households and firms may be putting off purchases as they wait to see whether the growing federal debt will be addressed through tax increases, and as policymakers determine how to implement regulatory changes in financial markets and health care. (See “Why Aren’t We Creating More Jobs?,” *Region Focus*, Third Quarter 2011.) To the extent that the labor market is weak for these “structural” reasons, catch-up inflation would

How Is the Fed Doing on Its Mandate?

Onlookers often gauge the Fed’s success in its “dual mandate” for monetary policy — price stability and maximum sustainable employment — according to common benchmarks. In recent years, the Fed has been assumed to target 2 percent inflation (it made the target explicit in 2012), while unemployment is often compared to estimates of its “natural” rate, a highly uncertain benchmark. The Congressional Budget Office currently estimates a natural rate of 5.5 percent, but many economists argue the natural rate is actually much higher due to structural factors following the recession.



NOTES: Inflation measured as year-over-year percent changes in the monthly Personal Consumption Expenditures price index. Grey bars denote recessions. Data through 2011 end.

SOURCES: Bureau of Economic Analysis, National Bureau of Economic Research



NOTES: Data are quarterly. Grey bars denote recessions. Data through 2011 end. SOURCES: Bureau of Labor Statistics, Congressional Budget Office, National Bureau of Economic Research

result in only that: inflation, with little improvement in growth or employment.

Structural factors are inherently difficult to quantify, however, and to some onlookers that makes them less convincing as a reason not to try more. “It is hard to believe that an additional 7 million Americans have suddenly lost the necessary skills to work in today’s economy,” Chicago Fed President Charles Evans said in a September 2011 speech. If his view is right, further easing might be effective. Consequently, he argued the Fed should be willing to miss its inflation target on the upside as well as the downside. “I do not see our 2 percent goal as a cap on inflation. Rather, it is a goal for the average rate of inflation over some period of time.” He would prefer to continue easing so long as inflation doesn’t rise above a threshold of 3 percent.

Ultimately, it is likely that both structural and cyclical factors are contributing to high unemployment, but no one precisely knows their relative importance. That makes the hoped-for benefits of higher inflation more uncertain.

Spending Credibility or Overdrawing the Account?

The main risk of raising inflation temporarily is that it could make inflation harder to contain in the future. That could

happen through the erosion of the Fed's credibility, which keeps inflation expectations anchored. Without it, expected inflation becomes in part a self-fulfilling prophecy: Rising prices get written into wage and other contracts, and constraining price pressures requires more drastic monetary tightening from the Fed.

It is possible that the Fed's credibility could start to unravel with a single inflationary move. The public knows from history that inflation is a slippery slope, as former Fed chairman Paul Volcker has observed. "[T]he danger is that if, in desperation, we turn to deliberately seeking inflation to solve real-world problems ... we would soon find that a little inflation doesn't work. Then the instinct will be to do a little more — a seemingly temporary and 'reasonable' 4 percent becomes 5, then 6 and so on," Volcker wrote in a September 2011 *New York Times* op-ed.

Volcker is widely credited with starting the Fed on the road to the credibility that today helps keep inflation expectations contained. He kept interest rates persistently high in the late 1970s and early 1980s, even as unemployment rose above 10 percent, to give markets reason to believe the Fed would follow through on its inflation objective. Markets have rarely doubted the Fed's commitment to low inflation since.

Supporters of price-level targeting say that such a policy would guide long-run inflation expectations by committing to an average rate of inflation (even while permitting short-term wings). In principle, that could allow consumers and businesses to make a pretty good guess about where average prices will be 20 years from now and aid them in making investment decisions. But a potential problem with adopting a price-level target expressly to make up for recessionary losses is the guesswork that the supposedly one-time move would create for the future. "You could say it's a one-time thing for all time, but the rationale would be more complicated," says John Taylor at Stanford University. The question becomes whether the adoption of a new regime is really believed to be a permanent shift in the approach to policy, or if instead people see it just as a way to get the current benefits of more inflation without credibly tying policymakers' hands in the future. Financial markets would have to forever guess when the Fed will deem economic conditions bad enough to warrant a similar move, a task that has already been made more difficult by the Fed's "rapidly changing tactics" of the last few years, in the words of St. Louis Fed President James Bullard.

Advocates of temporarily higher inflation, however, say that credibility is like a currency that allows the central bank to take policy risks in unusual situations. "These are times when the central banks need to spend some of the credibility that they accumulate in normal times," Harvard University economist Kenneth Rogoff argued in a syndicated op-ed. But no one knows how quickly the Fed's credibility could be cashed out. "Would the public really believe that the central bank is willing to push interest rates sky high and kill growth in order to contain inflation, after it abandoned its earlier inflation target in order to foster

growth?" University of Chicago's Raghuram Rajan wrote in a separate syndicated column. With less credibility, the Fed might have to take greater contractionary steps in the future to stymie inflation. That's why temporarily higher inflation would eventually create more unemployment and instability, not less, argued Philadelphia Fed President Charles Plosser in a November 2011 speech.

Another problem is that inflation hurts lenders at the expense of borrowers. To some economists, that is precisely the point. Recoveries following financial crises are especially slow and painful as households, businesses, and governments struggle to repair their over-leveraged balance sheets. "[T]here is no quick escape without a scheme to transfer wealth from creditors to debtors, either through defaults, financial repression, or inflation," Rogoff argued. But through inflation, the Fed would effectively be picking winners and losers of bad debts. Chicago's Rajan has written that the losers would include retirees on fixed incomes, pension funds, already-tapped state and local governments, and insurance companies, many whom purchased mortgage-backed debt during the boom, as well as households with variable-rate mortgages. In addition to being a bad way to address the debt problem, Plosser argued in his speech, the Fed ought to leave distributional policies to the democratic process of fiscal policy, or risk jeopardizing its independence as a consequence.

New Support for an NGDP Target

Rather than juggling both inflation and employment, some economists argue that the Fed should focus on a single variable: total spending in the economy, or nominal gross domestic product (NGDP). NGDP is everything that is produced times the current prices people pay for it. It is similar to "real" GDP, the measure of economic growth reported in the news, except NGDP isn't adjusted for inflation. One appeal is that growth in NGDP is the sum of exactly two things: inflation and the growth rate of real GDP (the amount of actual goods and services produced). Thus, it captures both sides of the Fed's mandate in a single variable.

Bennett McCallum, a professor at Carnegie Mellon University and a visiting scholar at the Richmond Fed, was one of the leading advocates of the idea of an NGDP target in the early 1980s. The traditional argument for it is that the Fed has greater control over total spending — which is linked tightly to the money supply — than either of its components, inflation and economic growth. In the long run, the Fed has full control over inflation, but in the short run its control is limited because prices don't adjust instantaneously to a change in the money supply — as economists would say, prices are "sticky."

To influence the economy, the Fed has to make an educated guess about how its changes to the money supply will break down between inflation and unemployment in the short run, also known as the Philips curve trade-off. The trouble is, that relationship is not well understood,

McCallum says. “I don’t think anybody can contest this: That relationship is the portion of any macro-econometric model that is most poorly understood and for which the results are most suspect.”

His idea was to get the Fed out of the business of managing real aggregate demand in the short run — how much emphasis it gives to employment relative to inflation — while achieving both targets in the long run. In the long run, the real economy has tended to grow at roughly 3 percent due to its inherent characteristics, virtually regardless of what policymakers have done. If that trend continues, an NGDP growth target of, say, 5 percent would tend to result in that 3 percent real growth rate over time and 2 percent inflation, roughly the Fed’s target. But in the short run, the Fed would let markets sort out how much NGDP growth comes from inflation and how much from economic growth. It’s not that central bankers should be indifferent between the two, McCallum says, “it’s that we know we can’t control it.”

Though NGDP targeting is not intended to create higher inflation, that is one possible outcome in the short run. This has made NGDP targeting an attractive prospect for those who already want inflation. A version recently advocated by Christina Romer of the University of California, Berkeley, formerly chair of the Council of Economic Advisers under President Obama, would even have the Fed target “catch-up” NGDP growth, similar in concept to a price-level target, making inflation an even more likely outcome in the near term.

NGDP targeting would be a more palatable way to “state a strategy that’s ultimately about something else,” Princeton’s Krugman wrote, favorably, on his blog. People balk at the prospect of inflation, but say you want to keep total spending in the economy on track, “and you’ve found a more acceptable way to justify huge quantitative easing and a de facto higher inflation target.” It’s not a deception, he wrote, but a communication strategy: If you’re of the camp that inflation will improve employment and avoid another depression, a policy billed as keeping national income on track is a more accurate description than simply “inflation.”

McCallum supports an NGDP target under his original logic rather than on the basis of its potential short-term benefits to an ailing economy. “The way I think about policy rules is that you adopt them because you think they’re going to do well on average over a long span of time,” he says, not because they suit the temporary conditions you happen to be in. NGDP targeting has received a recent burst of sup-

port for both sets of reasons, mostly through economics blogs and op-eds, but it is completely untested in the real world. No central bank is known to have explicitly tried it, even though NGDP is one of many indicators that the Fed and other central banks use as a barometer of economic conditions. A lot of unanswered questions remain about how it could be implemented and if it would really produce better economic outcomes in the long run than what the Fed does at present.

Changing the Rules

The Fed’s policymaking committee discussed NGDP targeting at its November 2011 meeting and provided a hint that major changes are not on the table. “We are not contemplating at this time any radical change in framework,” Chairman Bernanke said after the meeting. “We are going to stay within the dual mandate approach that we’ve been using until this point.”

Central bankers don’t take changes to the conduct of policy lightly. All central banks face the temptation to boost growth for temporary gain at the expense of longer-run price stability. To convince the public that monetary policy won’t give in to that temptation — to therefore maintain credibility and keep inflation anchored — many central banks stick to consistent “rules,” either explicit or implicit, to effectively tie their own hands. The best example is the “Taylor Rule,” devised by Stanford’s Taylor, which indicates how interest rates should be adjusted in response to how output and inflation are performing, and which has influenced the Fed’s policymaking discussions during the past 20 years.

But when should the policy rule change? History has shown that central bankers tend to wait until an idea is thoroughly tested in theory and, if possible, in practice by other central banks before trying them out for themselves. In the dominant theories of monetary policy, central banks can use abrupt changes to the policy rule to surprise the public and engineer a fleeting boost to economic activity. But there is the risk that an actual shift in procedure would be perceived by the public as an abandonment of the central bank’s longer-term objectives, thereby compromising both price stability and employment. The choices are made more difficult — and potentially more tempting — by the fact that many of the costs to changing procedure aren’t apparent until the future. As McCallum puts it, “The central bank is the one institution our country has that can take a somewhat longer-term view of things.” **RF**

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