Can Inflation Kickstart The Economy Without Killing It (Part II)?

Note: This is the SECOND of two related posts

In his latest New York Times Magazine column, Adam Davidson writes, "Like a defibrillator, inflation is a blunt tool that, used exceedingly sparingly, can sometimes save the patient."

To continue the discussion, we asked two economists on different sides of the debate — Edwin Truman, Senior Fellow at the Peterson Institute, and Jeffrey Miron, Senior Fellow at the Cato Institute — to answer the following question:

Would 5 percent inflation stimulate the economy or send it into a tailspin?

Jeffrey Miron's answer is below; To read Edwin Truman's answer, click here.

Many prominent economists believe the Fed should stimulate the economy by committing to an inflation target like 5 percent, rather than the current 2 percent. These economists argue that higher expected inflation means a lower real interest rate which can stimulate investment and hiring, thereby speeding up the economic recovery. This policy recommendation is logical as far as it goes. But it may not work, and it carries its own risks.

Higher inflation will not necessarily stimulate the economy because interest rates are not the only, and likely not the most important, factor that is limiting investment and hiring. Instead, pessimistic expectations by businesses about consumer demand, concern about an anti-business tilt in government policy, and fear of large tax increases to pay for entitlements, are plausibly playing larger roles. Thus raising the Fed's inflation target might generate higher inflation, with no other benefit to the economy.

The crucial difficulty with a higher target is managing the economy's expectations about inflation. On the one hand, political resistance to higher inflation might

generate a backlash once inflation starts to pick up, making it difficult for the Fed to stick to its new target. On the other hand, a higher inflation target might generate concern that inflation will not just reach 5% but soar beyond that point. This latter of these outcomes seems more likely, since U.S. debt situation is naturally raising fears that higher inflation is merely a way to devalue the debt. This is precisely what many economists are urging the European Central Bank to do about Europe's debt crisis.

Thus a higher inflation target has a consistent rationale in the hypothetical world where the Fed can credibly commit to this policy and manage the economy's expectations about inflation. In the real world, the task is more difficult.

A different problem is that higher inflation, whatever its merits in stimulating investment, would redistribute wealth from creditors to debtors. This will strike many citizens as arbitrary and unfair, implying a political outcry that may be hard to address. Occupy Wall Street and the Tea Party will find common cause. Perhaps the greatest harm from a higher inflation target is that it presumes the economy's struggles stem from inadequate "aggregate demand." If this is correct, it potentially makes sense to stimulate that demand.

But a different interpretation of our recent economic woes, and of the slow recovery in particular, is that the U.S. experienced a huge wealth shock when the housing bubble burst. At the same time, the surge in deficits called attention to our unsustainable fiscal policy. Both events revealed that the U.S. has been over-borrowing, over-consuming, and under-saving due to unrealistic assumptions about economic growth, about housing and stock prices, and about policy's ability to manage the economy.

Under this interpretation, higher investment does not make sense until consumers have rebuilt their buying power, and that will occur only gradually as consumers recover from the large hit to their wealth. Stimulative monetary policy might shift some investment from the future to the present, but this would not be productive because the investment will go under-used given the absence of consumer demand.

More broadly, the case for a higher inflation target – and for stimulative policies generally – takes as given that the U.S. economy can return to normal growth quickly. The "wealth shock" interpretation suggests that our slow recovery is inevitable, which means that attempts to fight it will be counterproductive.