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Higher Inflation Is a Lousy Cure for Meltdowns: Caroline Baum

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Commentary by Caroline Baum

Feb. 17 (Bloomberg) -- Policy makers are looking for measures to avert the next financial crisis. Most of the proposed solutions involve enhanced regulation. Economists at the International Monetary Fund have a better idea: higher inflation.

Yes, that's right. After a multidecade effort to become credible and anchor inflation expectations, central banks are now supposed to throw it all away in order to have more room to maneuver in financial crises.

Start with the inflation target, or ceiling, most central banks have adopted of 2 percent, multiply by five, add six, divide by four, and bingo! That's the new, improved inflation target of 4 percent, according to IMF economists Olivier Blanchard, Giovanni Dell'Ariccia and Paolo Mauro, authors of a new paper, "Rethinking Macroeconomic Policy."

Explicit inflation targeting has always been controversial for central banks with a dual mandate. The Federal Reserve, for example, is required to deliver stable prices and maximum sustainable employment. Some Fed officials eschew an explicit inflation target, preferring to retain the flexibility to respond to economic crises with lower interest rates even if inflation is above a target.

Just yesterday, Bank of England Governor Mervyn King had to inform Chancellor of the Exchequer Alistair Darling about his plan to rein in the 3.5 percent year-over-year increase in U.K. consumer prices in January, something he's required to provide when inflation exceeds the bank's 2 percent target by more than 1 percentage point. King attributed the outsized gain to "short-run factors," not a deterioration in the medium-term inflation outlook. In New Zealand, the central bank governor can be dismissed for failure to hit the policy target.

Happy Bedfellows

Stable prices and full employment used to be thought of as polar opposites. Experience taught us they're mutually exclusive. It turns out price stability is both an end in itself and a means to another end: achieving maximum long-run employment.

So what are we to make of the academic argument for a higher inflation target?

Many central banks lowered their benchmark policy rates to near zero in response to the financial crisis. The "zero bound," as it's known, circumscribes the path for nominal rates and may produce high real rates in the case of "deflationary recessions," the economists point out. It doesn't inhibit a central bank's ability to increase bank reserves by buying assets or making loans.

Good, Better, Best

Still, the zero bound has proven "costly," the economists write. "Higher average inflation, and thus higher nominal interest rates to start with, would have made it possible to cut interest rates more, thereby probably reduce the drop in output and the deterioration of fiscal positions," they say.

In other words, inflation needs to be higher so the Fed can push rates lower. That makes sense.

By that reasoning, if 4 percent is good, 8 percent should be better and 10 percent better yet!

It's not just monetary policy where the IMF economists think the authorities need room. Fiscal policy needs space, too.

"Some advanced economies that entered the crisis with high levels of debt and large unfunded liabilities have had limited ability to use fiscal policy," they say.

They must be referring to the U.S., with its $56.5 trillion in unfunded liabilities, which clearly did nothing to discourage trillions of dollars of expenditures on controversial bailouts and stimulus programs.

Earth to Academia

What planet do these academics live on? Last May Harvard University economists Ken Rogoff and Greg Mankiw joined a chorus advocating higher inflation. Rogoff lobbied "for at least 6 percent for a couple of years" to help the deleveraging process while Mankiw saw inflation as a better alternative to more stimulus packages and higher national debt.

"I don't understand how anyone who lived through the 1970s can say that," says Bill Poole, a senior fellow at Washington's Cato Institute and former president of the St. Louis Fed.

Poole says it's very unlikely inflation expectations could be stabilized at 4 percent or that the fiscal system could be indexed for inflation on a timely basis. Long-term interest rates would rise, delivering capital losses to bondholders. Higher inflation would punish savers -- something the nation could use more of. It would lead to inefficient allocation of capital. And it would sacrifice hard-won central bank credibility -- for what? Breathing room in case of another hundred-year flood?

Punchbowl's Punch

Prevention still seems like the best cure for financial crises. And like many Fed policy makers, Blanchard et al claim the fed funds rate is a "poor tool" for curbing financial excesses.

It may be. But when it comes to driving those excesses, nothing beats negative real rates. Government can require more capital, end the tax subsidy on leverage, as Poole suggests, and hope that regulators do what they're supposed to do. In the end, they'll be swimming upstream unless someone pulls the proverbial punchbowl.