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If Paul Krugman Gets The Higher Inflation He Wants, The U.S. Will Return To Recession

By Alan Reynolds
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U.S. inflation was 1.7% over the past year according to the consumer price index, or 1.4% as measured by personal consumption expenditures (PCE). That may sound like good news, yet we are being told it is actually very bad. "The Fed needs a clear strategy for getting the inflation rate higher," warns a recent news report, "after falling short of its 2 percent target for 28 consecutive months." Several eminent economists now argue that a 2% target is much too low, and the Fed must openly aim for 4% inflation to avoid "secular stagnation."

But this wrongheaded advice is based on dubious theory. In fact, inflation does not cause economic booms and economic booms do not cause inflation.

The phrase, "secular stagnation," which dates back to economist Alvin Hansen in 1938, was resurrected a year ago by Treasury Secretary Larry Summers at an International Monetary Fund event. According to the e-book *Secular Stagnation*, "A workable definition for secular stagnation is that negative real interest rates are needed to equate saving and investment with full employment." Since the Fed has kept the federal funds rate at zero for six years, secular stagnationists say the only way to get the real, inflation-adjusted fed funds lower is to push inflation higher—to 4%.

Paul Krugman's explanation

New York Times columnist Paul Krugman explains that, "People have to believe in higher inflation, which produces an economic boom, which yields the promised inflation. A necessary . . . condition for this to work is that the promised inflation be high enough that it will indeed produce an economic boom if people believe the promise will be kept."

Why does Krugman theorize that "high enough" inflation would produce an economic boom? "Investors expect inflation," he explains, "which makes them willing to spend more, which pushes the economy to full employment, which then generates the inflation investors expected."

This whole construction rests on flimsy foundations. For one thing, the pretense that central banks have the knowledge and skill to hit some precise inflation target is just academic hubris.

Since the Fed can't hit a 2% target with sufficient precision to please secular stagnationists, why assume the Fed could hit a 4% target?

Secular stagnationists also define real interest rates in ways that have no relevance to private incentives to borrow or save. Krugman defines real interest rates as the fed funds rate minus "core" inflation (excluding food and energy). Households and firms cannot borrow at the fed funds rate, and do not make decisions to save based on the fed funds rate.

Higher inflation has always increased the interest rates that really matter—long-term interest rates on mortgages and bonds. Even if the Fed could somehow persuade us to expect 4% inflation, would anyone really expect banks to still offer 4% mortgages and 3.5% prime loans?

Pushing real fed fund rates down wouldn't produce an economic boom

Would pushing the real fed funds rate even lower produce an economic boom? On the contrary, periods of rapid real growth of real GDP are accompanied by comparably high real interest rates in the fed funds market. Growth of real GDP averaged 4.2% a year from 1983 to 1989 and the real fed funds rate (after subtracting core PCE inflation) averaged 4.4%. Growth of real GDP averaged 3.8% a year from 1995 to 2000 and the real fed funds rate averaged 4.0%. In reality, prolonged episodes of negative real interest rates have only been observed in stagnant or declining economies.

Would 4% inflation really produce an economic boom? On the contrary, inflation above 4% is more often associated with recessions. The last time PCE inflation hit 4% was in July 2008 when the 10-year U.S. bond yield was 4.1% and the economy was deep in recession. The previous time the U.S. experienced 4% inflation was from January 1990 to February 1991 when the 10-year bond yield was 8.5% and the economy also slipped into recession. By contrast, inflation averaged 1.7% from the fourth quarter of 1996 through the third quarter of 2000, when year-to-year growth of real GDP averaged 4.5% a year.

You can't simply induce sustainable economic growth by having central bankers fiddle with inflation. Like endless excuses for inflation over the years, the newly revived secular stagnation hypothesis is impure snake oil.

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