



Written by [Jack Kenny](#) on November 1, 2013

Some Economists See Inflation as Cure for Sluggish Economy

President Obama's choice to succeed Federal Reserve Chairman Ben Bernanke next year, is among a number of influential economists who would welcome a higher rate of inflation to boost a stagnant economy and reduce unemployment, the *New York Times* [reported](#), noting "a growing concern inside and outside the Fed that inflation is not rising fast enough."

Inflation in one recent month, August, was measured at an annual rate of 1.2 percent, nearly the lowest rate on record. "Weighed against the political, social and economic risks of continued slow growth after a once-in-a-century financial crisis, a sustained burst of moderate inflation is not something to worry about," Harvard economist Kenneth Rogoff has written. "It should be embraced." Rogoff believes the Fed should push for an annual rate of inflation of about 6 percent.

"Low inflation is not good for the economy because very low inflation increases the risks of deflation, which can cause an economy to stagnate," Fed Chairman Bernanke said in July. Fears of a possible deflation are based on the belief that in an era of falling prices, people postpone purchases, thus contributing to a downward spiral of the economy. "The evidence is that falling and low inflation can be very bad for an economy," said Bernanke, whose efforts at stimulating the sluggish recovery from the last recession has included purchases by the central bank of \$85 billion a month in mortgage and Treasury bonds. The Federal Reserve recently [decided against a "tapering"](#) or reduction of those purchases until "the outlook for the labor market has improved substantially in a context of price stability." Unemployment stood at 7.2 percent of the labor force for September, according to the Bureau of Labor Statistics, though the official number does not include those who have stopped looking for work and those with only part-time jobs.

The dangers inherent in the Fed's "quantitative easing" are clear from recent memory. The oversubscription of mortgaged-backed securities led to the bubble in the housing market that burst in 2007-2008, sending financial markets into a tailspin. And underwriting public debt through purchase of more Treasury notes encourages Congress and the president to continue outspending revenues, conferring benefits while deferring costs to some indefinite time in the (hoped for) distant future. (Even the "conservative" long-term spending proposal advanced last year by House Budget Committee Chairman Paul Ryan would not produce a balanced budget until [some time around 2040.](#))

In fact, real inflation is not as low as the statistics we most often see suggest, as anyone knows who has pumped \$4-a-gallon gasoline into his car during the past year or has bought bread at the "bargain"





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price of \$2 a loaf at the neighborhood supermarket. The frequently cited “core inflation rate” does not include the volatile, and thus unpredictable, costs of food and fuel. And since 1983, the Bureau of Labor Statistics has been calculating the cost of home ownership not on house prices, but on “rental equivalence,” or the amount owner-occupants [“forgo by not renting out their homes.”](#)

Still, since the Fed, through its various phases of quantitative easing (QE I, QE II, and QE III) has purchased more than \$2.5 trillion in bonds and securities since 2008, it might seem surprising that we have not been overwhelmed by hyperinflation. But those purchases do not put more dollars into circulation. When the Fed “buys” bonds from banks, it merely credits those banks with reserves they didn’t have before. The banks then have added lending capacity, but have not increased lending for two reasons. In a weak economy there are fewer profitable lending opportunities. And since 2008, the Fed has been paying the banks interest on those excess reserves. [Bloomberg News](#) has estimated those payments could add up to \$77 billion a year, depending on how much interest rates rise by then.

The danger of rising inflation lies in the potential for increased lending against those added reserves, [warned](#) Martin Feldstein, the chairman of the Council of Economic Advisors during the Reagan administration.

The absence of significant inflation in the past few years does not mean that it won’t rise in the future. When businesses and households eventually increase their demand for loans, commercial banks that have adequate capital can meet that demand with new lending without running into the limits that might otherwise result from inadequate reserves. The resulting growth of spending by businesses and households might be welcome at first, but it could soon become a source of unwanted inflation.

On the other side, the *Times* named Yellen among the economists who “have long argued that a little inflation is particularly valuable when the economy is weak.” A [Bloomberg News report](#) earlier this year noted: “Federal Reserve Vice Chairman Janet Yellen has fought for more than a decade to put attacking unemployment and boosting growth on an equal footing with fighting inflation at the heart of the Fed’s policy.”

“The philosophy of Janet Yellen is activism of government policy to achieve objectives,” according to Allen Sinai, president of Decision Economics Inc.

While the legislation that created the Federal Reserve Board in 1913 charged the agency with the task of stabilizing prices, Congress in 1978 amended the law to create the “dual mandate” by giving the Fed the added mission of maximizing employment. Yellen is among the economists who believe that mission has been too long neglected in favor of fighting inflation.

Yellen earned her Ph.D. at Yale, where Professor James Tobin promoted Keynesian economics, holding that “pump-priming” through increased government spending and an expanded money supply are necessary to stimulate economic growth. In a [speech](#) she delivered at Yale in 1999, she suggested that the public suffers from an exaggerated fear of inflation. “Although most Americans apparently loathe inflation,” Yellen said, “Yale economists have argued that a little inflation may be necessary to grease the wheels of the labor market and enable efficiency-enhancing changes in relative pay to occur without requiring nominal wage cuts by workers.”

Professional economists are not alone in that belief. According to the *Times*, retailers like Costco and Walmart are looking hoping for higher inflation to increase profit margins. Richard Galanti, Costco’s chief financial officer recently cited low inflation as a reason for the company’s slow revenue growth,



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reflecting a benevolent view of inflation that he has had for some time. “I’ve always said that a little inflation is good,” he said in 2008.

Yet any increase in revenue and profits that businesses might experience from inflation is illusory. Customers may have more dollars to spend in an inflationary economy, but rising prices will offset and quickly reduce the purchasing power of those dollars. People faced with a higher cost of living will be less willing to pay more for the products on Costco’s shelves. And the higher wages that might otherwise attract more and better workers to traditionally low paying jobs will lose their attraction when rising prices reduce what employees can buy with their bigger paychecks. Paying employees with inflated dollars, in fact, is a way for companies to make those “efficiency-enhancing changes” Yellen described, without “nominal wage cuts.”

The same principle is at work in the recently concluded negotiations of the Anchorage, Alaska, school board and the local teachers’ union. Teachers accepted a one-percent pay raise for each of the next three years, the *Times* reported, believing it was better than no raise at all. But if, as economists predict, inflation will run at a mere two percent a year for the next three years, the teachers’ pay will effectively be reduced by one percent a year. And if inflation should go higher — say at the six-percent rate that Harvard’s Rogoff considers ideal — the few more dollars Anchorage residents might find in their paychecks will probably not persuade them that they should pay more in taxes to help the school board cover its budget shortfall.

Since the creation of the Federal Reserve System a century ago, the dollar has lost 95 percent of its purchasing power. Just since 2000, the U.S. dollar has [declined in value](#) against other major currencies by 31 percent. Cycles of boom and bust have occurred repeatedly under the Fed’s watchful eye. And the idea of inflation as a cure for unemployment should bring back memories of the late 1970s when the nation suffered both double-digit inflation and stagnant economy, giving currency to the word [“stagflation”](#)

Economists who think we need more inflation should be careful. We all might get what they wish for.



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