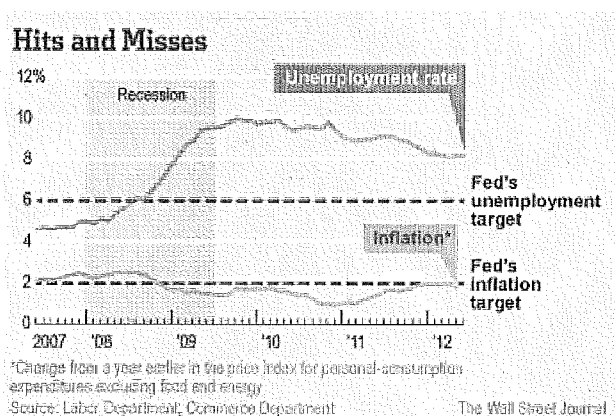


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Number of the Week: Could Inflation Revive the Recovery?

By Ben Casselman



4.2%: How high inflation would be if the Fed allowed prices to stray as far from its target as unemployment has.

The **Federal Reserve** has a dual mandate to promote both price stability and maximum employment. It's a delicate balancing act: Focus too much on keeping inflation in check and the Fed runs the risk of strangling growth, driving up unemployment; focus too much on promoting hiring and inflation can quickly spin out of control.

Fed Chairman **Ben Bernanke** was on Capitol Hill this week to explain how the Fed is striking that balance. To judge by the questions they asked, most of Mr. Bernanke's critics in Congress think the Fed's easy-money policies are raising the risk of runaway inflation in the future.

But outside of Congress, much of the criticism of Mr. Bernanke argues that he's strayed too far in the opposite direction, worrying too much about inflation — which might be a problem in the future, but doesn't appear to be right now — and too little about the unemployment rate, which pretty much everyone agrees is too high.

In a speech last fall, Chicago Fed President **Charles Evans** laid out the argument this way: The Fed's implicit inflation target is 2%. The Fed doesn't have a widely cited numerical target for unemployment, but a conservative estimate of the "natural," or underlying, rate of unemployment is 6%.

"So, if 5% inflation would have our hair on fire," Mr. Evans said in September, "so should 9% unemployment."

Unemployment has come down some since last fall, but it's still at 8.2%, nowhere close to the Fed's "maximum employment" mandate. By Mr. Evans's logic (which he explains more fully in his speech), the current rate of joblessness is equivalent to inflation running at 4.2% — more than double the Fed's target rate.

Mr. Evans has argued the Fed should consider allowing inflation to run above its target until unemployment falls to some pre-determined — and pre-announced — level. He got more support for that position this week from economists **Menzie Chinn**, of the **University of Wisconsin** (and also the blog [Econbrowser](#)), and **Jeffrey Frieden**, of **Harvard**. In a [new article](#) in the **Milken Institute Review**, the two economists argue that if fiscal stimulus, quantitative easing and an alphabet-soup of mortgage relief programs haven't been enough to kick-start the recovery, it's time to try inflation.

The big factor holding back economic growth in both the U.S. and Europe, the two economists say, is debt: Consumers, companies and governments are all struggling under the burden of huge debts run up during the boom years, making it harder for them to spend, borrow and invest.

That diagnosis of the problem — they cite "[This Time Is Different](#)," **Carmen Reinhart** and **Kenneth Rogoff**'s now-famous study of financial crises — is fairly mainstream at this point. But their prescription isn't: Ease the burden on debtors by allowing inflation to rise.

"Raising the expected rate of inflation would reduce the real burden of debt on households, corporations and governments, spurring both investment and consumption," Profs. Chinn and Frieden write, arguing the Fed should allow inflation to run "in the 4 to 6 percent range for several years."

The authors recognize their proposal will likely be "met with howls of indignation" from creditors, who would see a policy of intentional inflation — which would reduce the value of their bonds — as an expropriation of their assets. "To an extent, they are right," the economists say.

But one way or another, they continue, those debts aren't going to be repaid in full, whether it's through inflation, default, bankruptcy or negotiated settlements. Better to do it in a way that's quick and, because it treats all debts equally, at least relatively fair. The logic is the same as in bankruptcy proceedings, they write: "For creditors, something is better than nothing; for debtors, relief is better than default; for both, certainty is better than uncertainty."

Messrs. Chinn and Frieden join other prominent economists, [including Mr. Rogoff](#) and left-leaning economists [such as Paul Krugman](#), in arguing for more inflation. But one important economist they don't look likely to win over: Mr. Bernanke. In this week's testimony, Mr. Bernanke left little doubt that he opposes raising the inflation target, even temporarily. (Mr. Bernanke has plenty of prominent backers for his position, too, [including former chairman Paul Volcker](#).)

"I don't think that's a strategy that has a lot of support on the Federal Open Market Committee," Mr. Bernanke [said in response to a question](#) from North Carolina Republican **Patrick McHenry**. Among other problems, Mr. Bernanke said, if the Fed raised its inflation target from 2% to 4%, businesses and households might reasonably wonder whether they could raise it again in the future. Such a loss of confidence in the Fed's discipline could make it harder for the Fed to control inflation in the future.

Messrs. Chinn and Frieden argue that linking the inflation target to a specific unemployment rate would help keep inflation expectations in check. But given Mr. Bernanke's comments — and given that even hinting at support for inflation amounts to political poison — they aren't likely to see that theory put to the test anytime soon.

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