IMF tells bankers to rethink inflation

By Bob Davis

February 12, 2010 – *The Wall Street Journal*

The International Monetary Fund's top economist, Olivier Blanchard, says central bankers should consider aiming for a higher inflation rate than they do currently to lessen the chances of repeating the recent severe recession.

Mr. Blanchard, a macroeconomist on leave from the Massachusetts Institute of Technology, said the global economic downturn revealed flaws in macroeconomic policy, especially the reliance primarily on interest rates to manage economies. Although Japan had fallen into a decade-long funk despite low inflation and low interest rates, "most people convinced themselves that the Japanese didn't know what they were doing," Mr. Blanchard said in an interview.

In a new paper with two other IMF economists, Giovanni Dell'Ariccia and Paolo Mauro, Mr. Blanchard says policy makers need to consider radically different approaches to deal with major banking crises, pandemics or terrorist attacks. In particular, the IMF paper suggests shooting for a higher-level inflation in "normal time in order to increase the room for monetary policy to react to such shocks." Central banks may want to target 4% inflation, rather than the 2% target that most central banks now try to achieve, the IMF paper says.

At a 4% inflation rate, Mr. Blanchard says, short-term interest rates in placid economies likely would be around 6% to 7%, giving central bankers far more room to cut rates before they get near zero, after which it is nearly impossible to cut short-term rates further.

"Now we realize that if we had a few hundred extra basis points" — a basis point is one-hundredth of a percentage point — "to rely on, that would have helped" fight the recent downturn, Mr. Blanchard says. "So it would have been good to start with a higher nominal rate. The only way to get there is higher inflation."

For decades, the IMF has pressed countries to slash inflation and counts as a major accomplishment its success in persuading governments in Latin America, Africa and elsewhere to abandon the idea that they could inflate their way to prosperity. But Mr. Blanchard says the IMF should lead the rethinking necessary after the worst recession since World War II.

Most big-country central bankers, recalling the mistakes they made that led to high inflation rates in the 1970s and 1980s, aren't likely to immediately embrace the IMF advice. They remain convinced that keeping inflation low, and persuading markets that they will do so, remains critically important. John Taylor, a Stanford University monetary-policy specialist who served in the Bush administration Treasury department, says that inflation could become hard to constrain if the target is raised. "If you say it's 4%, why not 5% or 6%?" Mr. Taylor said. "There's something that people understand about zero inflation."

Mr. Blanchard argues that there isn't much difference in maintaining inflation at 2% or 4%. Tax brackets could be adjusted so that higher inflation, by itself, doesn't push taxpayers into higher tax rates. Inflation-adjusted bonds could protect investors. The IMF paper notes the possibility that inflation could jump higher if governments start adjusting wages automatically for inflation, "but the question remains whether these costs are outweighed by the potential benefits" in terms of avoiding zero interest rates.

The new paper, titled "Rethinking Macroeconomic Policy," also recommends that central banks use regulatory weaponry try to prick asset bubbles before they grow dangerously large. Relying exclusively on raising interest rates to do such work risks damage to the broader economy, an argument that Federal Reserve Chairman Ben Bernanke has made.

"If leverage appears excessive, regulatory capital ratios can be increased," the paper says. "To dampen housing prices, loan-to-value ratios can be decreased; to limit stock price increases, margin requirements can be increased."

Mr. Blanchard says governments should rethink the design of automatic stabilizers — spending increases or tax cuts that are triggered by a recession. The classic stabilizer is unemployment insurance, spending on which increases automatically as more workers lose jobs. Governments could design new programs that have more bang for the buck, he says, such an automatic reduction in taxpayer bills when the gross domestic product declines by a certain percentage. Another possibility: an investment tax credit that takes effect when economic activity slows down. "Companies would get it automatically without Congress having to vote on it," Mr. Blanchard says.