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Not Enough Inflation

By PAUL KRUGMAN

Ever since the financial crisis struck, and the Federal Reserve began "printing money" in an attempt to contain the damage, there have been dire warnings about inflation — and not just from the Ron Paul/Glenn Beck types.

Thus, in 2009, the influential conservative monetary economist Allan Meltzer warned that we would soon become "inflation nation." In 2010, the Paris-based Organization for Economic Cooperation and Development urged the Fed to raise interest rates to head off inflation risks (even though its own models showed no such risk). In 2011, Representative Paul Ryan, then the newly installed chairman of the House Budget Committee, raked Ben Bernanke, the Fed chairman, over the coals, warning of looming inflation and intoning solemnly that it was a terrible thing to "debase" the dollar.

And now, sure enough, the Fed really is worried about inflation. You see, it's getting too low.

Before I get to the trouble with low inflation, however, let's talk about what we should have learned so far.

It's not hard to see where inflation fears were coming from. In its efforts to prop up the economy, the Fed has bought more than $2 trillion of stuff — private debts, housing agency debts, government bonds. It has paid for these purchases by crediting funds to the reserves of private banks, which isn't exactly printing money, but is close enough for government work. Here comes hyperinflation!

Or, actually, not. From the beginning, it was or at least should have been obvious that the financial crisis had plunged us into a "liquidity trap," a situation in which many people figure that they might just as well sit on cash. America spent most of the 1930s in a liquidity trap; Japan has been in one since the mid-1990s. And we're in one now.

Economists who had studied such traps — a group that included Ben Bernanke and, well, me — knew that some of the usual rules of economics are in abeyance as long as the trap lasts. Budget deficits, for example, don't drive up interest rates; printing money isn't inflationary; slashing government spending has really destructive effects on incomes and employment.

The usual suspects dismissed all this analysis; it was "liquidity claptrap," declared Alan Reynolds of the Cato Institute. But that was four years ago, and the liquidity trappers seem to have been right, after all.

And it's worth mentioning another issue on which the inflation non-worriers have been vindicated: how to measure inflation trends. The Fed relies on a measure that excludes food and energy prices, which fluctuate widely from month to month. Many commentators ridiculed this focus on "core" inflation, especially in early 2011, when rising food and energy prices briefly sent "headline" inflation above 4 percent even as the core stayed low. But, sure enough, inflation came back down.

So all those inflation fears were wrong, and those who fanned those fears proved, in case you were wondering, that their economic doctrine is completely wrong — not that any of them will ever admit such a thing.

And, at this point, inflation — at barely above 1 percent by the Fed's favored measure — is dangerously low.

Why is low inflation a problem? One answer is that it discourages borrowing and spending and encourages sitting on cash. Since our biggest economic problem is an overall lack of demand, falling inflation makes that problem worse.

Low inflation also makes it harder to pay down debt, worsening the private-sector debt troubles that are a main reason overall demand is too low.

So why is inflation falling? The answer is the economy's persistent weakness, which keeps workers from bargaining for higher wages and forces many businesses to cut prices. And if you think about it for a minute, you realize that this is a vicious circle, in which a weak economy leads to too-low inflation, which perpetuates the economy's weakness.

And this brings us to a broader point: the utter folly of not acting to boost the economy, now.

Whenever anyone talks about the need for more stimulus, monetary and fiscal, to reduce unemployment, the response from people who imagine themselves wise is always that we should focus on the long run, not on short-run fixes. The truth, however, is that by failing to deal with our short-run mess, we're turning it into a long-run, chronic economic malaise.

I wrote recently about how, by allowing long-term unemployment to persist, we're creating a permanent class of unemployed Americans. The problem of too-low inflation is very different in detail, but similar in its implications: here, too, by letting short-run economic problems fester we're setting ourselves up for a long-run, perhaps permanent, pattern of economic failure.

The point is that we are failing miserably in responding to our economic challenge — and we will be paying for that failure for many years to come.