Paul Krugman - New York Times Blog

May 24, 2013, 11:02 am

The Four Percent Solution

Larry Ball makes the case that we would be a lot better off with a 4 percent inflation target rather than the 2 percent that is now central bank orthodoxy. Intellectually, this position is hardly outlandish; indeed, Ball’s case is very similar to the case Olivier Blanchard made three years ago, just stated more forcefully and with more evidence.

The basic point is that a higher baseline for inflation would make liquidity traps, in which conventional monetary policy is up against the zero lower bound, less likely and less costly when they happen. Ball estimates that if we had come into this crisis with an underlying inflation rate of 4 percent, average unemployment over the past three years would have been two percentage points lower. That’s huge — it amounts to millions of jobs and trillions of dollars of extra output.

There are two main arguments against a higher inflation target. One is that events like the current crisis almost never happen. My view would be that the costs of this crisis are so large — and the difficulties we’ve had in responding so grotesque — that even if they were once-in-75-year events, that should be enough to warrant different policies. But Ball also argues that the risk of liquidity-trap events is much greater than conventional wisdom would have you believe. Just looking at US experience, the last three recessions were all “postmodern” recessions caused by private-sector overreach, not Fed tightening — and in each case the Fed had a very hard time getting traction. Both 1990-91 and 2001 were near misses in terms of the liquidity trap; 2007 onwards was actually in line with what had become the normal pattern, not a bizarre exception.

By the way, one point Ball doesn’t mention is that to the extent that we consider Japan’s issues partly demographic, that’s becoming the norm too: low fertility and, perhaps, low resulting investment returns are also becoming standard among advanced countries. Again, this calls for a higher inflation target.

The other argument is some kind of slippery slope thing: you decide that 4 percent is OK, and the next thing you know you’re Jimmy Carter, or maybe Weimar. As Ball says, there is really no evidence for this fear. It’s true that it’s what almost all central bankers believe; but they can’t really explain why, and we should never forget that there was once a time when almost all central bankers believed that going off the gold standard would mean the end of civilization.

The point is that the conventional 2 percent target is a prejudice, nothing more; it once rested to some extent on studies suggesting that 2 percent was enough to make the zero lower bound a non-problem, but we now know how utterly wrong that view was; so we’re left with a target that’s considered respectable because it’s what all the respectable people say, and is what all the respectable people say because it’s considered respectable.

What do we want? Four percent! When do we want it? Now!