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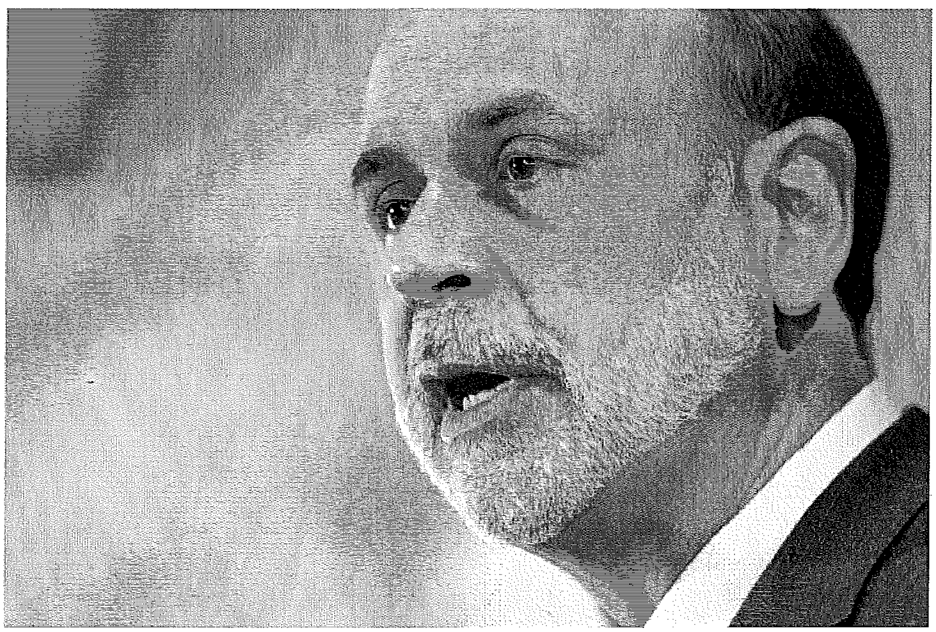
How to Save the Global Economy: Whip Up Inflation. Now.

BY MENZIE CHINN, JEFFRY FRIEDEN | JAN/FEB 2012



The American and European debt crises have dragged on for years now. Yet none of the heavily indebted countries -- not the United States, not the peripheral eurozone borrowers -- has been able to use a traditional weapon to fight the debt crisis: inflation. This has been the crucial difference between the current crisis and similar ones in the past.

Recovery from a debt crisis is always painfully slow, for reasons both economic and political. Creditors need to rebuild their balance sheets and are unwilling to make potentially risky loans. Debtors need to boost savings to cover their debts and are unwilling to resume spending. At the same time, debt-ridden countries collapse into political conflict over the question of who will pay to get them out of the red: Should it be taxpayers, bankers, public workers, or investors?

A bit of inflation can help on all these fronts. So long as the debts are denominated in national currency and interest rates are kept low by monetary policy, inflation reduces the real debt burden. This is, to be sure, a forced restructuring that puts some of the onus on creditors -- but that is almost always the outcome of more explicit negotiations in any case. When most of the debts are household debts, as they are in the United States and parts of the eurozone, it is not really feasible to renegotiate millions of mortgages and consumer loans; inflation takes care of that for the whole economy. It mitigates some of the political conflict and lessens some of the economic burden.

So far, though, none of the major debtors has been able to make this option work. The most troubled eurozone debtors -- Greece, Ireland, Italy, Portugal, and Spain -- don't make their own monetary policy, so they cannot inflate away a share of their debt. Indeed, two-thirds to three-quarters of the foreign debts of Greece, Portugal, and Spain are owed to eurozone creditors, primarily in Germany and France. Even Ireland, which has strong financial ties to Britain and the United States, owes about half its debts to other eurozone countries. This means that if the European Central Bank decided to pursue inflation, it would be taking money out of the pockets of creditors that are also members of the eurozone -- and powerful members, too. As politically daunting as this might be, however, some such redistribution would almost certainly be part of any durable settlement of the eurozone debt crisis anyway -- and the apparent inability of Europe's leaders to arrive at such a settlement in anything near a timely fashion has only further confirmed that inflation may be the only politically feasible way forward.

For its part, the U.S. Federal Reserve has run a monetary policy appropriately focused on stimulating the economy, keeping interest rates extremely low, and engaging in "quantitative easing," whereby it twice increased purchases of long-term Treasury securities and mortgage-backed securities. This effort has not, however, been enough to raise prices by more than trivial amounts. The Fed policy should theoretically lead to an export-boosting depreciation of the dollar, but every attempt to moderate the dollar's value so far has been met by countervailing efforts on the part of the big surplus countries, especially China. These policies have also been countered by the dollar's continuing strength as a perceived safe haven in the midst of crisis: Domestic and international investors still think of Treasury securities as the most reliable place to park their money in uncertain times, a view that has maintained the dollar's value in spite of the Fed's interventions.

We're not proposing a lot of inflation -- just enough to reduce the debt burden to more manageable levels, which probably means in the 4 to 6 percent range for several years. The Fed could accomplish this by adopting a flexible inflation target, one pegged to the rate of unemployment. Chicago Fed President Charles Evans has proposed something very similar, a policy that would keep the Fed funds rate near zero and supplemented with other quantitative measures as long as unemployment remained above 7 percent or inflation stayed below 3 percent. Making the unemployment target explicit would also serve to constrain inflationary expectations: As the unemployment rate fell, the inflation target would fall with it.

Today our highest priority should be to stimulate investment, growth, and employment. Raising the expected inflation rate will lower real interest rates and spur investment and consumption. It will also make it difficult for the de facto dollar peggers, such as China, to sustain their policies. The resulting real depreciation of the dollar would stimulate production of U.S. exports and domestic goods that compete with imports, boosting American production. The United States would get faster growth, an accelerated process of deleveraging, a quicker recovery, and a firmer foundation upon which to address long-term fiscal problems.

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