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The 4% non-solution

Kenneth Rogoff | Harvard University | 10 June 2014

For some time now, there has been concern that central bankers have "run out of bullets". Having lowered their policy rates to near zero, they have engaged in increasingly extravagant measures such as quantitative easing and forward guidance. Given the fog cast over real economic activity by the financial crisis, it is difficult to offer a definitive assessment of just how well or badly those measures have worked. But, it is clear that there must be a better way to do things.

There is no longer any reason to let the zero bound on nominal interest rates continue to hamper monetary policy. A simple and elegant solution is to phase in a switchover to a fully electronic currency, where paying interest, positive or negative, requires only the push of a button. And, with paper money – particularly large-denomination notes – arguably doing more harm than good, currency modernisation is long overdue. Using an electronic currency, central banks could continue to stabilise inflation exactly as they do now. (Citigroup's chief economist, Willem Buiter, has suggested numerous ways to address the constraint of paper currency, but eliminating it is the easiest.)

A second, less elegant idea is to have central banks simply raise their target inflation rates from today's norm of 2% to a higher but still moderate level of 4%. The idea of permanently raising inflation targets to 4% was first proposed in an interesting and insightful paper led by IMF chief economist Olivier Blanchard, and has been endorsed by a number of other academics including, most recently, Paul Krugman. Unfortunately, the problem of making a smooth and convincing transition to the new target is perhaps insurmountable.

When Blanchard first proposed his idea, I was intrigued but skeptical. Mind you, two years previously, at the outset of the financial crisis, I suggested raising inflation to 4% or more for a period of a few years to deflate the debt overhang and accelerate wage adjustment. But there is a world of difference between temporarily raising inflation to address a crisis and unhinging long-term expectations.

After two decades of telling the public that 2% inflation is Nirvana, central bankers would baffle people were they to announce that they had changed their minds – and not in some minor way, but completely. Just recall the market's taper tantrums in May 2013, when then-Fed Chairman Ben Bernanke suggested a far more modest turn in monetary policy. People might well ask why, if central bankers can change their long-term inflation target from 2% to 4%, could they not later decide that it should be 5% or 6%?

Given the likelihood of a confused, mistrustful public, it is hard to find any deep rationale for a 4% inflation target. At least the existing 2% inflation target stands for something, because central bankers can portray it as the moral equivalent of zero. (Most experts believe that a true welfare-based price index would show significantly lower inflation than government inflation statistics indicate, because official data fail to capture the benefits of the constant flow of new goods into the economy.)

There is an analogy to the problems countries faced when they tried to re-establish the gold standard after World War I. Until the war, money was backed by gold and could be redeemed at a fixed rate. Though the system was highly vulnerable to bank runs and there was little scope for a monetary stabilisation policy, people's confidence in the system enabled it to anchor expectations. Unfortunately, the system completely collapsed after the war broke out in August 1914. Revenue-desperate combatants were forced to turn to inflation finance. They could not simultaneously debase the currency and back it with gold at a fixed rate.

After the war, as things settled down, governments tried to return to gold, partly as a symbol of a return to normalcy. But, the revived inter-war gold standard ultimately fell apart, in no small part because it was impossible to rebuild public trust. A move by central banks to a long-term 4% inflation target risks triggering the same dynamic.

Fortunately, there is a much better way. Moving to an electronic government currency would not require a destabilising change in the inflation target. Minor technical issues could easily be ironed out. For example, ordinary citizens could be allowed zero-interest-transactions balances (up to a limit). Presumably, nominal interest rates would move into negative territory only in response to a deep deflationary crisis.

But, when such a crisis does occur, central banks could power out of it far more quickly than is possible today. And, as I have argued elsewhere, governments have long been penny-wise and pound-foolish to provide large-denomination notes, given that a large share are used in the underground economy and to finance illegal activities. Moving to a twenty-first-century currency system would make it far simpler to move to a twenty-first-century central-banking regime as well.

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