Let the Central Bankers Inflate

Worries about central banks trying to create inflation are overblown.

In two recent posts, **Martin Feldstein** and **Andrew Sentance** (former member of the Bank of England monetary policy committee) criticise the recent actions of central banks to bring inflation back to its 2 percent target.

Andrew Sentance clearly misses the central bankers of the 1980s, the fighters against high inflation. He has an interesting definition of a central banker's job:

"*The job of a central banker is to make unpopular decisions when politicians will not. We saw that in the 1970s and 1980s from the Bundesbank and the U.S. Federal Reserve.*"

And, unfortunately, central bankers are not fighting inflation anymore (maybe because inflation is too low?):

"*It is a measure of how much has changed in the world of central banking that the very institutions that won their credibility by keeping a lid on prices now seem to be trying to create inflation, not subdue it.*"

And it gets even worse when he looks back at 2011:

"*Central banks now seem ready to do whatever it takes to sustain growth — to a degree that casts doubt on the genuineness of their commitment to price stability. Monetary policy deliberately turned a blind eye to relatively high inflation in 2011-12.*"

There are two central banks that were worried about inflation in those years: the ECB and the Swedish central bank. [I'm] not sure they are the example to follow.

What both articles share is an asymmetric view of inflation. In some sense inflation can only be too high. High inflation represents a real risk with significant costs while inflation below target might just be OK (despite all the evidence to the contrary of the recent crisis).

Their criticisms would have a lot more power if inflation was going up anywhere in the world, but it is isn't. So they need to find another cost of this unreasonable policy of trying to raise inflation back to its target. And what Martin Feldstein finds is the financial instability that "low interest rates" create (a point also made by many other critics of current central bank actions).

But, as **Paul Krugman** points out, it is really odd to hear these arguments coming from those who tend to believe in the power and efficiency of markets (relative to government policies). How can it be that financial markets are so easily fooled by monetary policy and end up mispricing assets in such a bad way as to create a bubble that will have large and negative consequences on the economy? Because we are not just talking about asset prices going up as interest rates are low, we are talking about bubbles and instability. If this is really what we believe, wouldn't this be an argument to enforce some strong regulation on markets that are unable understand how interest rates and other macroeconomic trends affect asset prices?

This is not to deny that periods of unusually low interest rates can indeed create confusion in investors and markets (what some call "search for yield"). But to make this argument, one needs to first understand the global nature of this phenomenon that suggests that the reasons for low interest rates extend beyond the particular actions of a central bank. And then we need a theory of financial markets, their irrational behaviour and how the central bank can influence this behaviour. It is unclear to me that the history of financial market bubbles teaches us much about the ability of central banks to stop excessive optimism. Real interest rates in the 1990s were high and they did not stop the largest stock market bubble the U.S. stock market has ever seen.

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