

# Inflation Targets Reconsidered

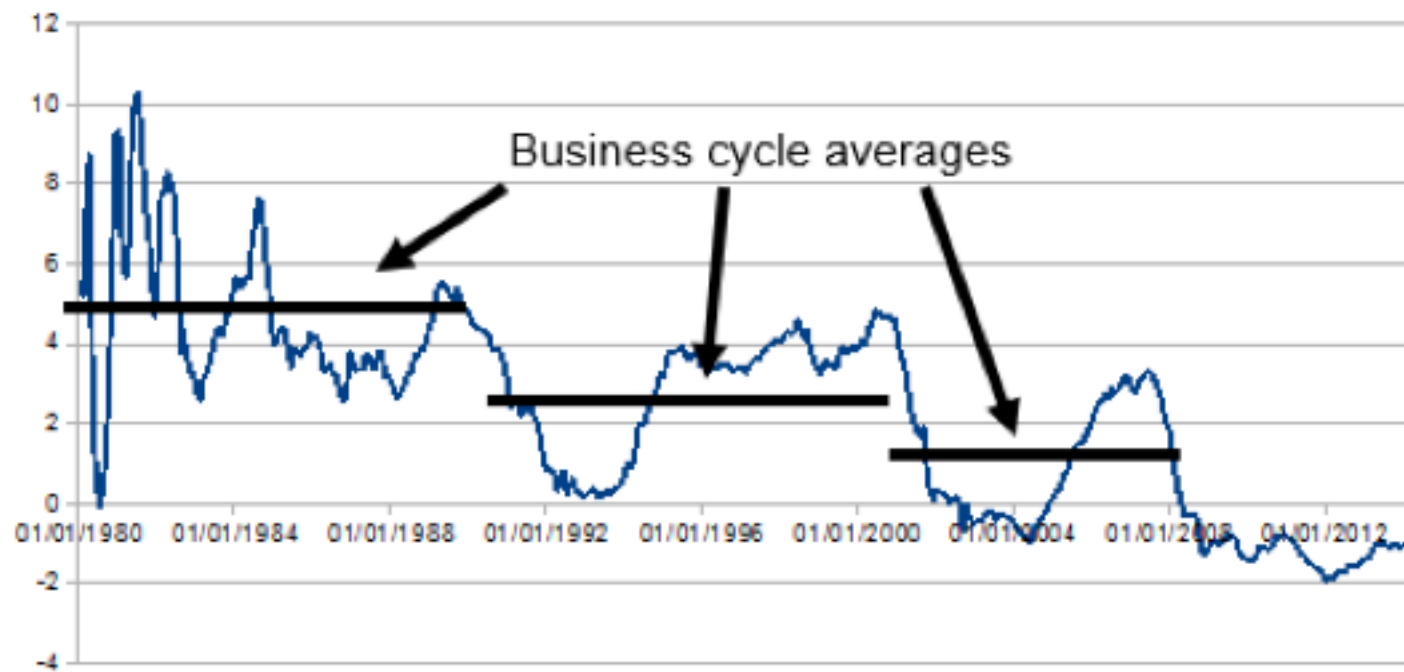
Paul Krugman

The mysterious doctrine of 2 percent. Why?

1. ZLB episodes regarded as unlikely at that rate
2. DNWR regarded as unlikely to be seriously binding
3. Price stability advocates offered a measurement fig leaf

We now know that 1&2 not true. But also good reason to fear a low-inflation trap, so that there is option value to reducing the odds of falling in

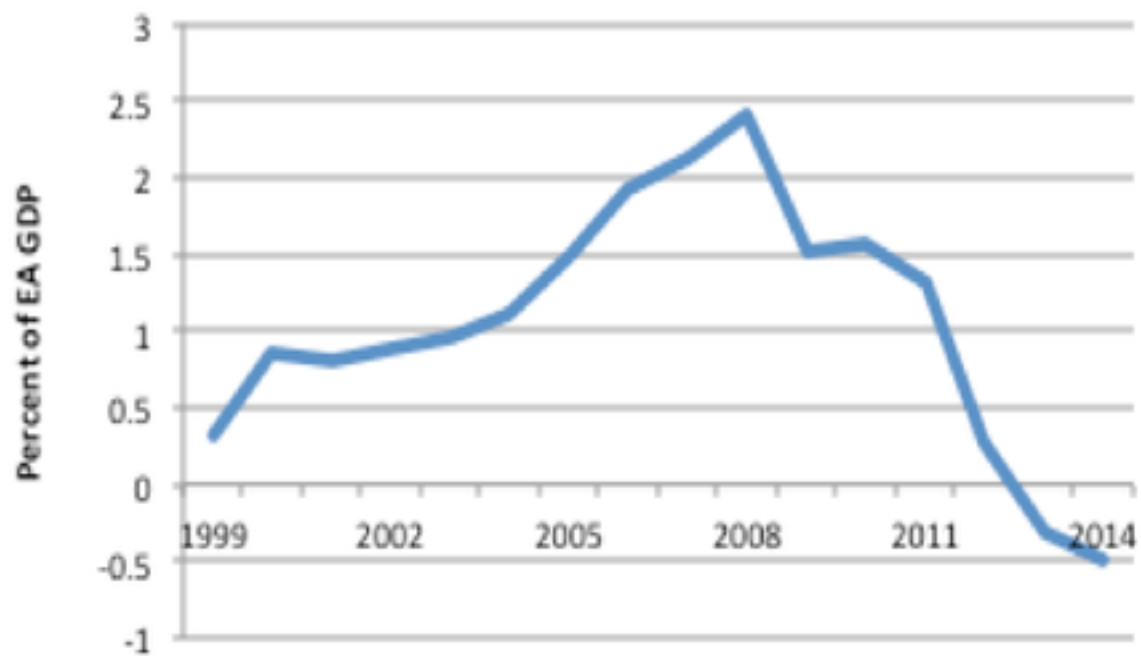
### Real interest rate



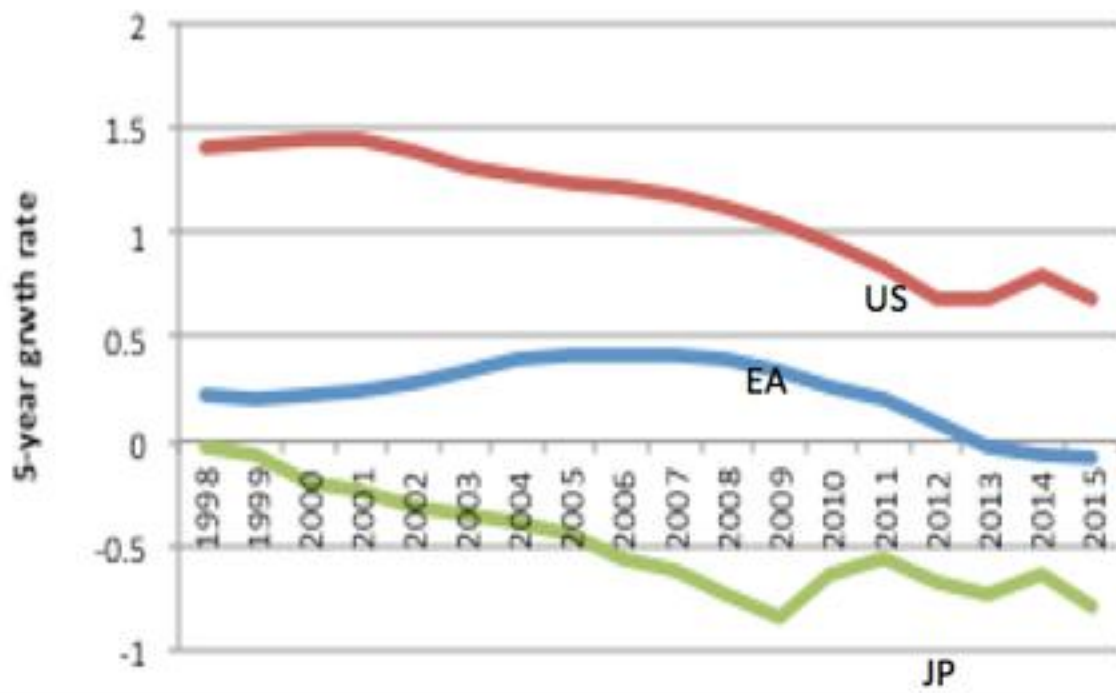
## Household liabilities as % of GDP

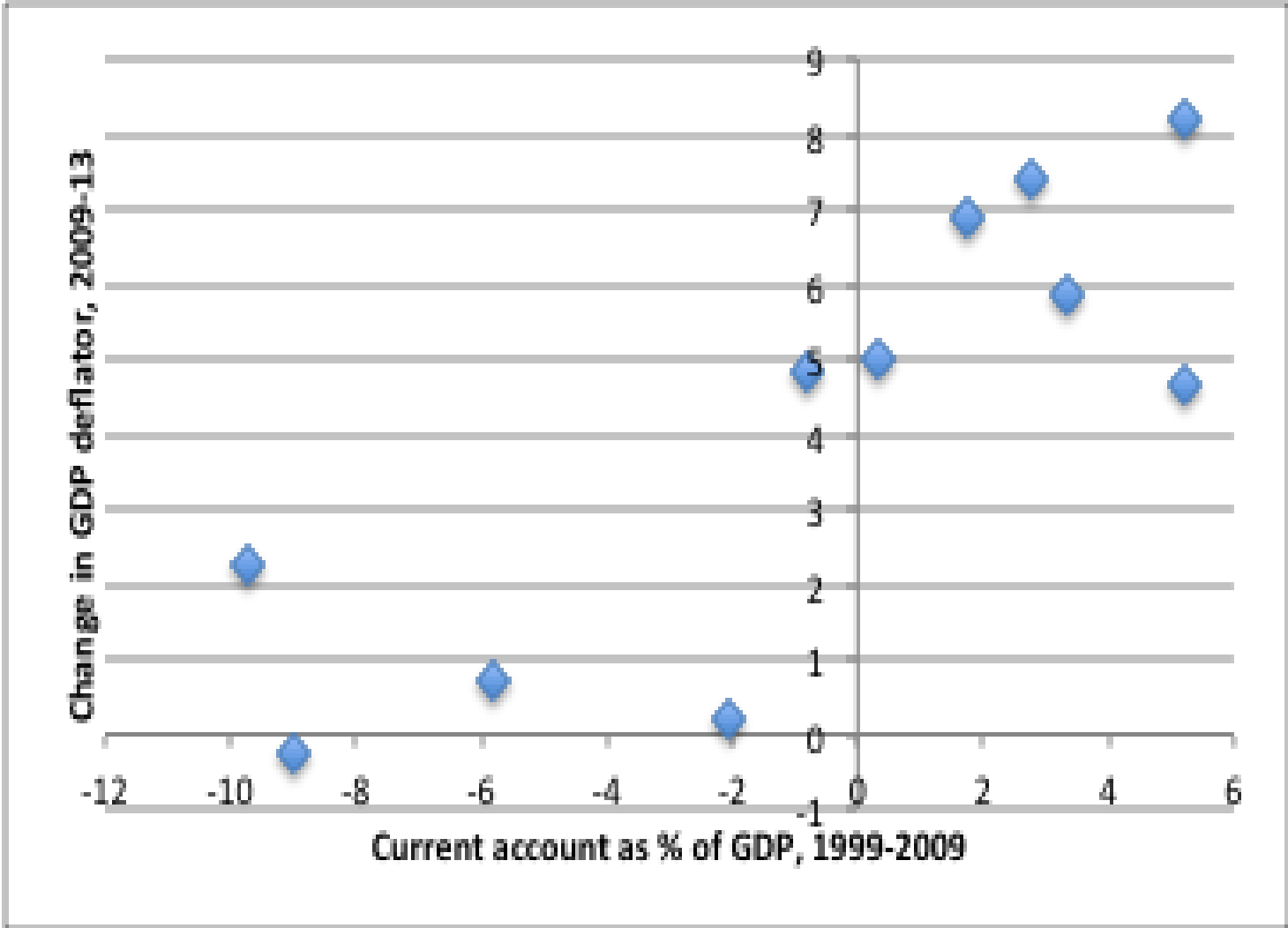


## PGIIS deficits

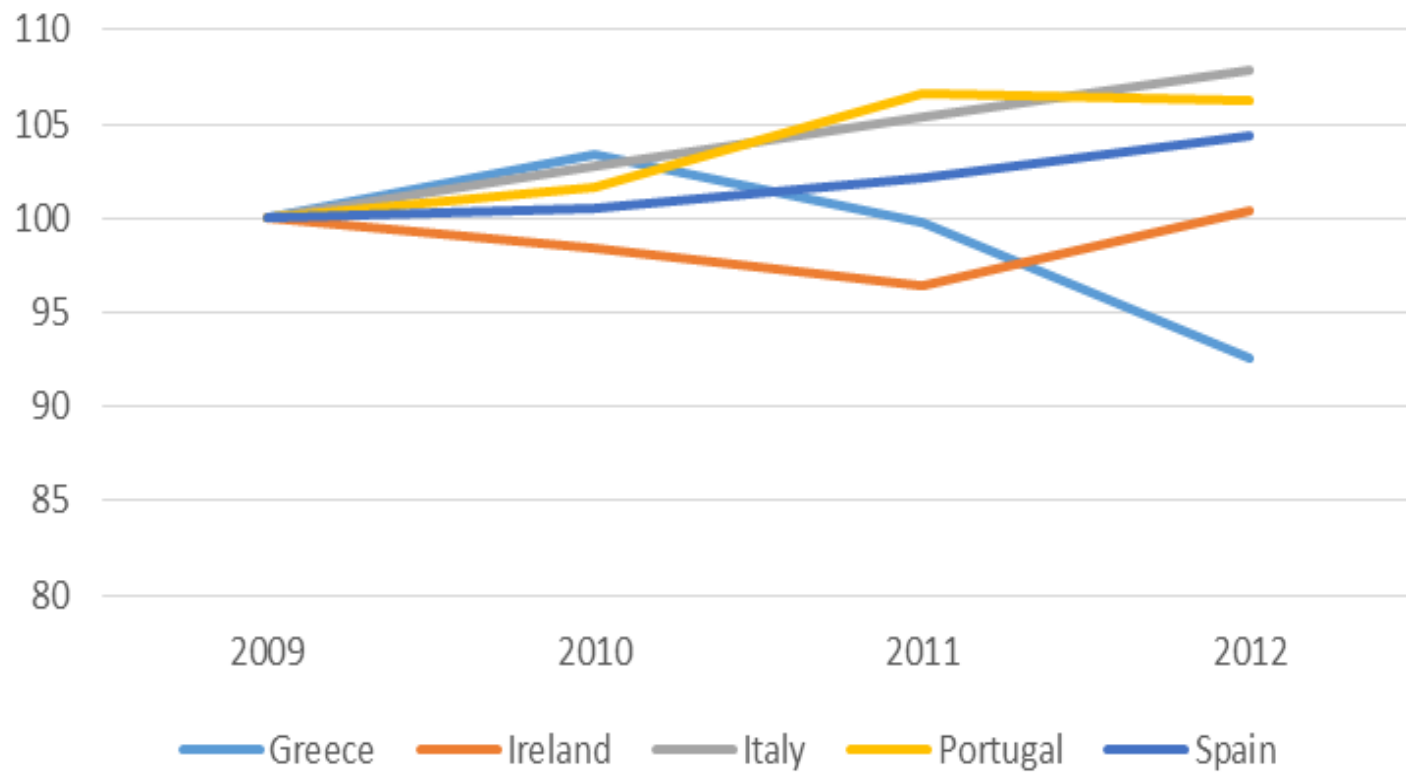


## Population 15-64





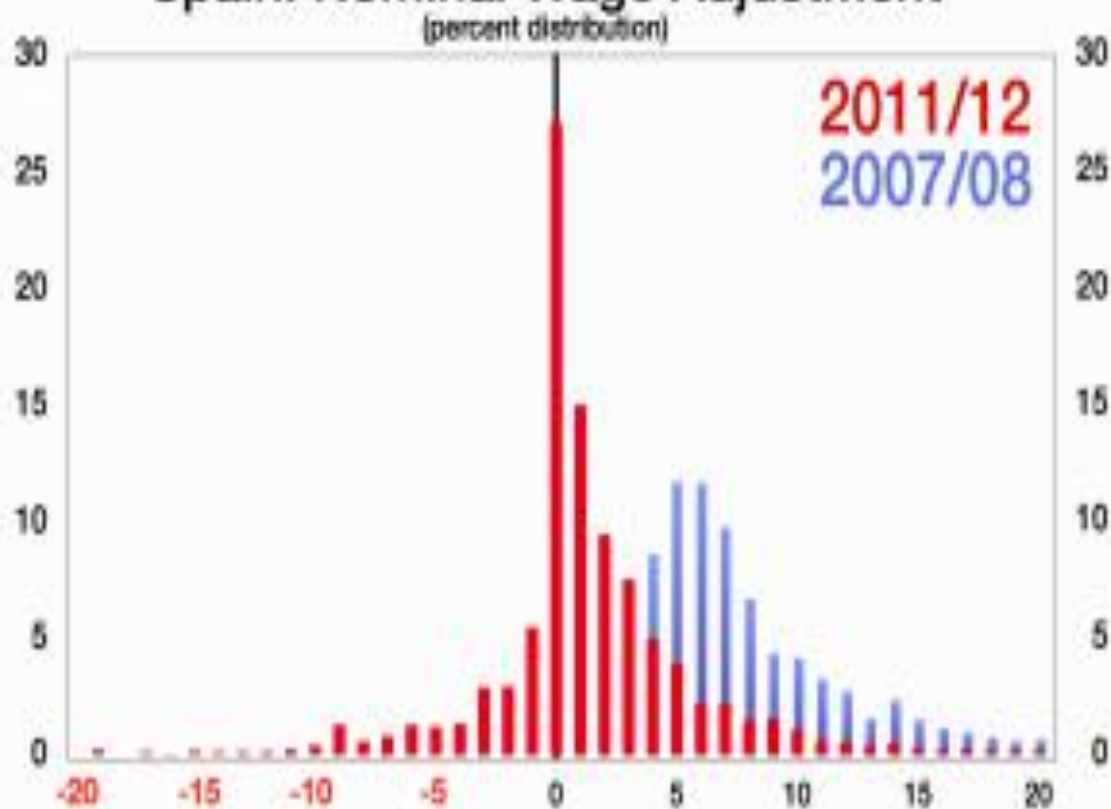
## Hourly compensation in manufacturing, 2009=100





# DEFLATION — A REAL RISK?

## Spain: Nominal Wage Adjustment



Source: A. Arellano, M. Jensen, S. Jiménez (2013)

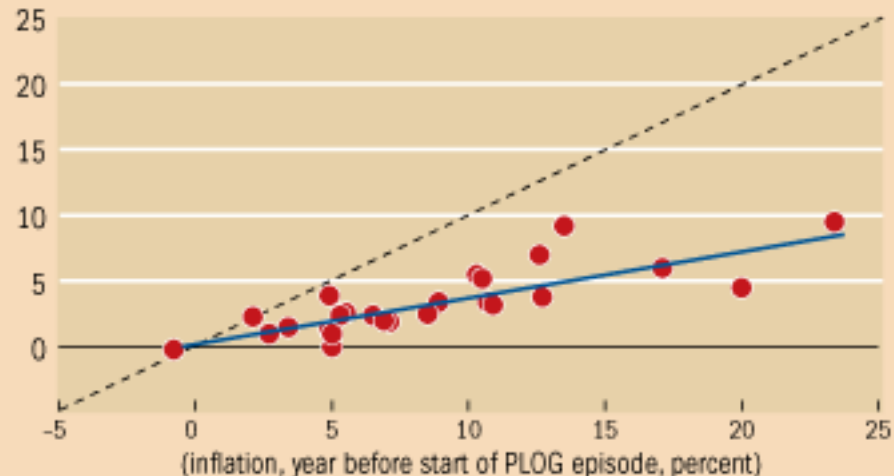
# Low inflation traps: complacency, credibility, timidity

Chart 1

## Inflation conquered

Inflation declined during almost all of 25 serious recession episodes in advanced economies between 1970 and 2007. The two times inflation rose, it did so from very low rates and the increases were negligible.

(inflation, final year of PLOG episode, percent)

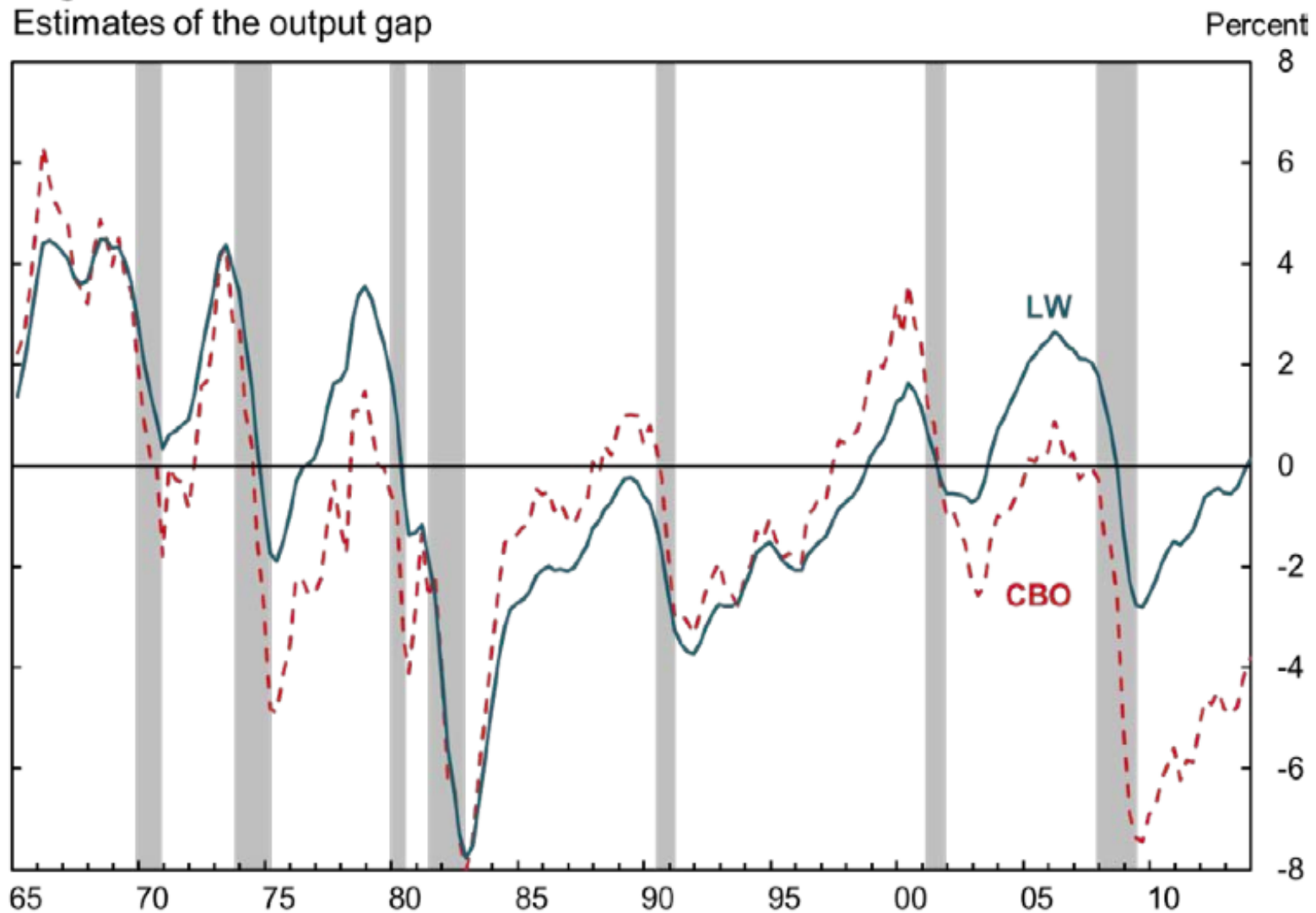


Source: Meier (2010).

Note: A persistent large output gap (PLOG) episode is a period in which output remained at least 1.5 percent below potential for more than eight consecutive quarters. There were 25 PLOG episodes in 14 advanced economies. Inflation is measured by changes in the consumer price index at a seasonally adjusted annual rate.

**Figure 1.**

Estimates of the output gap



## Draghi on deflation:

Deflation is a protracted fall in prices across different commodities, sectors and countries. In other words, it is a generalised protracted fall in prices, with self-fulfilling expectations. Therefore, it has explosive downward dynamics. We do not see anything like that in any country.

...

If we were to see deflation, we would have to sit down and think carefully, but we do not see it.

...

First, the fact that inflation is low is not, by itself, bad; with low inflation, you can buy more stuff. Second, we don't see deflation and that is what we have to fear. We don't see that yet.

## A Timidity Trap?

