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Op-Ed Columnist

Misguided Monetary Mentalities

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One lesson from the Great Depression is that you should never underestimate the destructive power of bad ideas. And some of the bad ideas that helped cause the Depression have, alas, proved all too durable: in modified form, they continue to influence economic debate today.

What ideas am I talking about? The economic historian Peter Temin has argued that a key cause of the Depression was what he calls the “gold-standard mentality.” By this he means not just belief in the sacred importance of maintaining the gold value of one’s currency, but a set of associated attitudes: obsessive fear of inflation even in the face of deflation; opposition to easy credit, even when the economy desperately needs it, on the grounds that it would be somehow corrupting; assertions that even if the government can create jobs it shouldn’t, because this would only be an “artificial” recovery.

In the early 1930s this mentality led governments to raise interest rates and slash spending, despite mass unemployment, in an attempt to defend their gold reserves. And even when countries went off gold, the prevailing mentality made them reluctant to cut rates and create jobs.

But we’re past all that now. Or are we?

America isn’t about to go back on the gold standard. But a modern version of the gold standard mentality is nonetheless exerting a growing influence on our economic discourse. And this new version of a bad old idea could undermine our chances for full recovery.

Consider first the current uproar over the declining international value of the dollar.

The truth is that the falling dollar is good news. For one thing, it’s mainly the result of rising confidence: the dollar rose at the height of the financial crisis as panicked investors sought safe haven in America, and it’s falling again now that the fear is subsiding. And a lower dollar is good for U.S. exporters, helping us make the transition away from huge trade deficits to a more sustainable international position.

But if you get your opinions from, say, The Wall Street Journal's editorial page, you're told that the falling dollar is a terrible thing, a sign that the world is losing faith in America (and especially, of course, in President Obama). Something, you believe, must be done to stop the dollar's slide. And in practice the dollar's decline has become a stick with which conservative members of Congress beat the Federal Reserve, pressuring the Fed to scale back its efforts to support the economy.

We can only hope that the Fed stands up to this pressure. But there are worrying signs of a misguided monetary mentality within the Federal Reserve system itself.

In recent weeks there have been a number of statements from Fed officials, mainly but not only presidents of regional Federal Reserve banks, calling for an early return to tighter money, including higher interest rates. Now, people in the Federal Reserve system are normally extremely circumspect when making statements about future monetary policy, so as not to step on the efforts of the Fed's Open Market Committee, which actually sets those rates, to shape expectations. So it's extraordinary to see all these officials suddenly breaking the implicit rules, in effect lecturing the Open Market Committee about what it should do.

What's even more extraordinary, however, is the idea that raising rates would make sense any time soon. After all, the unemployment rate is a horrifying 9.8 percent and still rising, while inflation is running well below the Fed's long-term target. This suggests that the Fed should be in no hurry to tighten — in fact, standard policy rules of thumb suggest that interest rates should be left on hold for the next two years or more, or until the unemployment rate has fallen to around 7 percent.

Yet some Fed officials want to pull the trigger on rates much sooner. To avoid a "Great Inflation," says Charles Plosser of the Philadelphia Fed, "we will need to act well before unemployment rates and other measures of resource utilization have returned to acceptable levels." Jeffrey Lacker of the Richmond Fed says that rates may need to rise even if "the unemployment rate hasn't started falling yet."

I don't know what analysis lies behind these itchy trigger fingers. But it probably isn't about analysis, anyway — it's about mentality, the sense that central banks are supposed to act tough, not provide easy credit.

And it's crucial that we don't let this mentality guide policy. We do seem to have avoided a second Great Depression. But giving in to a modern version of our grandfathers' prejudices would be a very good way to ensure the next worst thing: a prolonged era of sluggish growth and very high unemployment.

