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# A Cross of Rubber

By PAUL KRUGMAN

Last Saturday, reported The Financial Times, some of the world's most powerful financial executives were going to hold a private meeting with finance ministers in Davos, the site of the World Economic Forum. The principal demand of the executives, the newspaper suggested, would be that governments "stop banker-bashing." Apparently bailing bankers out after they precipitated the worst slump since the Great Depression isn't enough — politicians have to stop hurting their feelings, too.

But the bankers also had a more substantive demand: they want higher interest rates, despite the persistence of very high unemployment in the United States and Europe, because they say that low rates are feeding inflation. And what worries me is the possibility that policy makers might actually take their advice.

To understand the issues, you need to know that we're in the midst of what the International Monetary Fund calls a "two speed" recovery, in which some countries are speeding ahead, but others — including the United States — have yet to get out of first gear.

The U.S. economy fell into recession at the end of 2007; the rest of the world followed a few months later. And advanced nations — the United States, Europe, Japan — have barely begun to recover. It's true that these economies have been growing since the summer of 2009, but the growth has been too

slow to produce large numbers of jobs. To raise interest rates under these conditions would be to undermine any chance of doing better; it would mean, in effect, accepting mass unemployment as a permanent fact of life.

What about inflation? High unemployment has kept a lid on the measures of inflation that usually guide policy. The Federal Reserve's preferred measure, which excludes volatile energy and food prices, is now running below half a percent at an annual rate, far below the informal target of 2 percent.

But food and energy prices — and commodity prices in general — have, of course, been rising lately. Corn and wheat prices rose around 50 percent last year; copper, cotton and rubber prices have been setting new records. What's that about?

The answer, mainly, is growth in emerging markets. While recovery in advanced nations has been sluggish, developing countries — China in particular — have come roaring back from the 2008 slump. This has created inflation pressures within many of these countries; it has also led to sharply rising global demand for raw materials. Bad weather — especially an unprecedented heat wave in the former Soviet Union, which led to a sharp fall in world wheat production — has also played a role in driving up food prices.

The question is, what bearing should all of this have on policy at the Federal Reserve and the European Central Bank?

First of all, inflation in China is China's problem, not ours. It's true that right now China's currency is pegged to the dollar. But that's China's choice; if China doesn't like U.S. monetary policy, it's free to let its currency rise. Neither China nor anyone else has the right to demand that America strangle its nascent economic recovery just because Chinese exporters want to keep the renminbi undervalued.

What about commodity prices? The Fed normally focuses on "core" inflation, which excludes food and energy, rather than "headline" inflation, because experience shows that while some prices fluctuate widely from month to month, others have a lot of inertia — and it's the ones with inertia you want to

worry about, because once either inflation or deflation gets built into these prices, it's hard to get rid of.

And this focus has served the Fed well in the past. In particular, the Fed was right not to raise rates in 2007-8, when commodity prices soared — briefly pushing headline inflation above 5 percent — only to plunge right back to earth. It's hard to see why the Fed should behave differently this time, with inflation nowhere near as high as it was during the last commodity boom.

So why the demand for higher rates? Well, bankers have a long history of getting fixated on commodity prices. Traditionally, that meant insisting that any rise in the price of gold would mean the end of Western civilization. These days it means demanding that interest rates be raised because the prices of copper, rubber, cotton and tin have gone up, even though underlying inflation is on the decline.

Ben Bernanke clearly understands that raising rates now would be a huge mistake. But Jean-Claude Trichet, his European counterpart, is making hawkish noises — and both the Fed and the European Central Bank are under a lot of external pressure to do the wrong thing.

They need to resist this pressure. Yes, commodity prices are up — but that's no reason to perpetuate mass unemployment. To paraphrase William Jennings Bryan, we must not crucify our economies upon a cross of rubber.



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