May 4, 2009, *8:57 am*

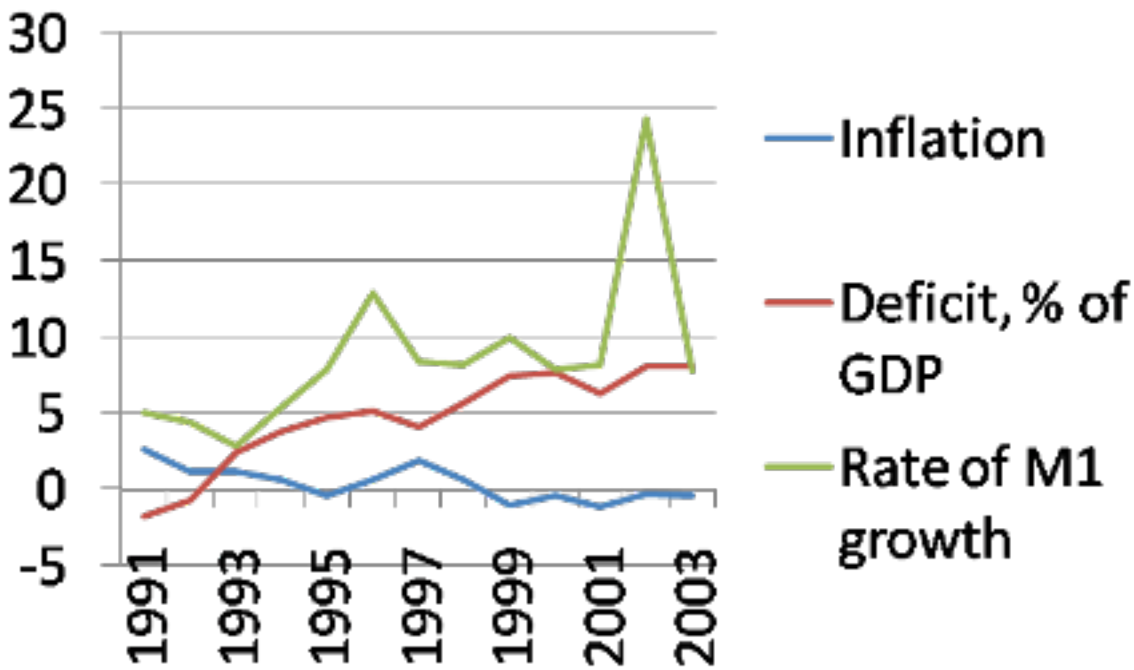
A history lesson for Alan Meltzer

Paul Krugman

From [today's Times](#):

Besides, no country facing enormous budget deficits, rapid growth in the money supply and the prospect of a sustained currency devaluation as we are has ever experienced deflation. These factors are harbingers of inflation.

Japan's lost decade:



Source: IMF, OECD

A History Lesson for Paul Krugman

By Allan H. Meltzer
May 5, 2009, 1:51 pm
After I published a piece in the New York Times op-ed page warning of future inflation (see: "Inflation Nation"), Paul Krugman claimed to offer me a "history lesson" on his Times blog (see his post: "A History Lesson for Alan [sic] Meltzer").

In the piece I argued that no country with rapid money growth, a large budget deficit, and an expected depreciation of the exchange rate has ever experienced deflation, always inflation. He claims Japan's "lost decade" as a counterexample. It is not. I am very familiar with Japan during this period—I served as honorary adviser to the Bank of Japan and met often with the then Governor Hayami. He opposed using monetary expansion, and I did not convince him that he was making a mistake. In the midst of the deflation, he raised the interest rate to avoid "sloppy" money markets. That was the wrong thing to do as several of us told the Bank of Japan at the time.

When Governor Fukui replaced Governor Hayami, he carried out the policy that I had urged Governor Hayami to follow. He bought long-term bonds.

The deflation ended, contrary to the advice of Professor Krugman, who claimed at the time that monetary policy was in a "liquidity trap" and useless. He was wrong then and he neglects that, unlike the United States today, Japan financed its excess spending from domestic saving. We have to borrow from others. The Chinese have sent several signals warning that they may be reluctant to finance our outrageously large deficits.

On the op-ed page in the Times on which we both appeared, Professor Krugman repeats the same message he writes regularly. We differ about the degree to which the Federal Reserve and the administration should concentrate solely on the near-term problems of the economy instead of considering the medium- and longer-term effects of their current actions. Tomorrow comes and a well run central bank neither ignores today's problems nor neglects tomorrow's. Wages are not falling, no matter how many times Professor Krugman reminds us that they might. To avoid the inflation that it is creating, the Federal Reserve should be less expansive.
(American Enterprise Institute)

A Broken Record on Deflation

By Allan H. Meltzer
June 1, 2009, 5:55 am

How many more times must Paul Krugman tell us that we have to worry about deflation? (See an earlier exchange on this topic here.) Most others who shared his concern in December or January have learned that they were wrong. Some recognized the error as a failure to recognize that falling oil and food prices reduce the price level, not its sustained rate of change. Deflation and inflation refer to rates of change, not levels. Others recognize that oil prices have increased, so even a decline in the price level now seems unlikely.

It's a pity that Krugman gives his readers a potted history of economic policy. Postwar inflation was a principal means the government used to reduce the wartime debt. And inflation was the way we reduced the debt again in the 1970s. I'm not sure which history he reads, but it does not get the facts right.

Krugman's overriding concern is the current mess. More astute observers think that concern for present problems should not forsake future problems that arise because they are neglected. That single-minded focus on the unemployment rate brought the Great Inflation of the 1970s. Certainly the current Federal Reserve should provide money to avoid bank runs and to restore growth, and they have. But part of our current problem is a productivity shock to financial markets that has reduced the profitability of financial services. The Federal Reserve can do nothing about that.

Most economists have learned that it takes about two years from the time monetary stimulus increases to the beginning of inflation. Prudent central bankers take that lag into account. Krugman and the Federal Reserve do not. They wait for the inflation to occur. That's too late to avoid its costs.

Does the Federal Reserve have the technical ability to prevent inflation? Certainly! Will the Federal Reserve show the political stomach in the face of a sluggish recovery and almost certain cries of alarm from Chairman Barney Frank, the administration, the business community, the labor unions, and Krugman? Certainly not!