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# The Conscience of a Liberal

Paul Krugman



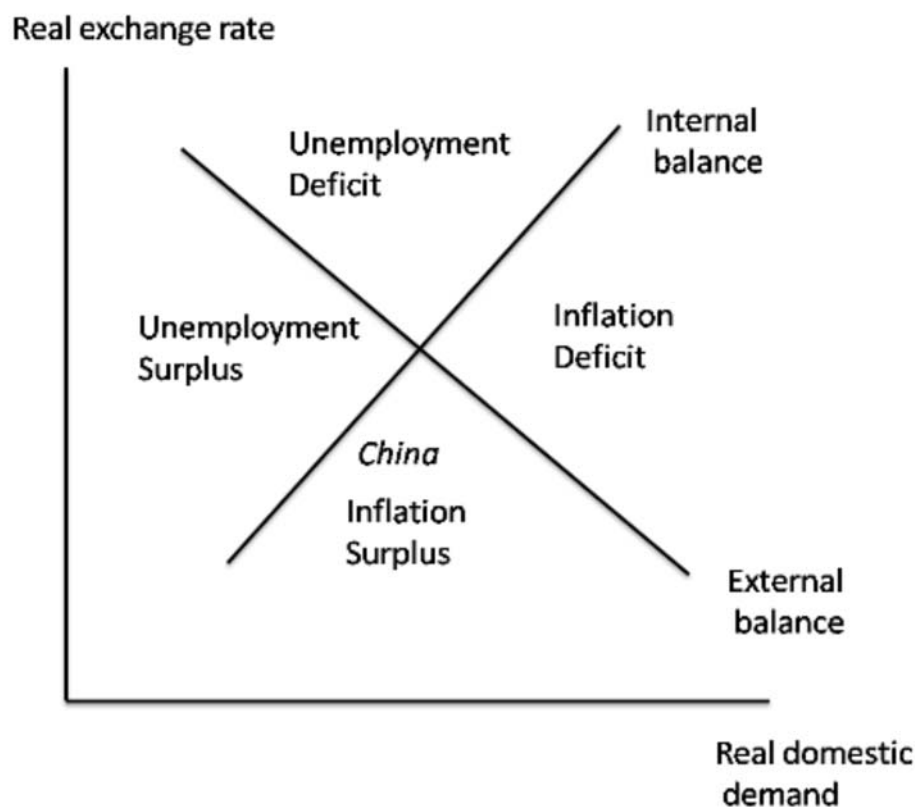
March 11, 2010, 1:28 pm

## China's Swan Song

Today's markets are being somewhat roiled by news of accelerating inflation in China, leading to worries that China [will have to tighten monetary policy](#). But, you know, that's not what China is supposed to do in this situation.

There's an oldie but goodie in international macro known as the Swan Diagram — not [instructions for making an origami swan](#), but the insightful analysis developed by the Australian economist Trevor Swan. He suggested that we think of countries as having two objectives — keeping unemployment as low as is consistent with stable inflation, but not lower — and keeping the trade balance at an acceptable level. He also suggested that we think of two kinds of policies: things like monetary and fiscal policy that affect the overall level of domestic spending, and exchange rate policy that affects the competitive position of exporters and import-competing industries.

He summarized all this with a diagram:



There are four “zones of economic unhappiness”; getting out of them requires some combination of exchange rate adjustment and changes in domestic demand.

So where's China? It's clearly in the lower zone: a trade surplus at levels that is raising international tension, plus inflation. It's actually not clear which way domestic demand should do — but renminbi appreciation is clearly indicated, *for China's own sake*, not just to head off the outraged reactions of the rest of the world.

There are obviously political considerations keeping the Chinese from doing the right thing. But with a little encouragement — say, a Treasury report saying that yes, they do manipulate their currency — things might happen.

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1.

El Cid

Atlanta, GA

March 12th, 2010

2:29 pm

Logically you may have a point, but too many Americans seem to be weirdly infatuated with the rhetoric and metaphor of a "strong" dollar. Maybe it's that ridiculously repeated term "strong".

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2.

The Raven

Seattle, WA

March 12th, 2010

2:29 pm

Prof, you're rational, these people aren't.

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[3.](#)

Joseph OShaughnessy

Downers Grove, IL

March 12th, 2010

2:29 pm

I think it is pretty far down the list of things to worry about.

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Andy Baumgardt

Yorkville, IL

March 12th, 2010

2:29 pm

Doesn't monetary tightening leading to an appreciating currency? How else are they going to get their currency to appreciate without monetary tightening?

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Texas

March 12th, 2010

2:29 pm

We can hope for such a report Dr. K., but if it materializes, indications are it would have had to arrive at Treasury on GS letter-head to ever receive further distribution, since only GS can counter-weight corporate lobbyists liking the ability to build plants in China with Chinese backing and guarantees that if the enterprise does not work out, corporations can walk away owing nothing.

Raising the point that the Obama administration should have the same policy, and when attacked by the right, simply say " We are defending American markets " - succinct, to the point sound-bite.

Furthermore, the unions in this country should adopt a mantra of " We want it back " to counter-act the corporate lobbyists who are supported by the Chief Justice in his comments at the Univ. of Alabama Law School this week.

btw-it is fatuous in the extreme for the Chief Justice to characterize the mouthed response of Justice Alito as ' judicial temperament ' when a 5-year old can look at the video and turn to ask his parents " what did that man say, mommy ? "; the Chief's remarks indicate how dire our situation is and that there is no time to waste.

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Chris Martin

Alameda, CA

March 12th, 2010

2:29 pm

This would contradict China's longstanding commitment to Mercantilism at all costs.

- Wonks Anonymous

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Northern California

March 12th, 2010

2:29 pm

If China goes down, the whole world economy will slip into another, even worse recession. Same with Greece and the weak economies of the EU. The U.S. has done nothing to rein in the derivatives gambling going on. We are poised for an even bigger crash of the world economy if just one thing comes loose in this globalist economic house of cards. If that happens, Americans may experience a level of suffering not seen in 80 years. I wish we could pull the plug on the oligarchs in the USA who have outsourced American jobs and dumbed down the American public. Of course the first thing they'd cut in a new downturn would be the poor and middle class, but not the 2 wars or the fat cats. Obama is worthless as far as being a leader. I voted for him but consider myself rooked by this Chicago-style corrupt politician.

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8.

[Pluto Finnigan](#)

Gainesville, FL

March 12th, 2010

2:29 pm

Why not criticize the Chinese currency manipulation on grounds that it rewards the rich in China at the expense of the masses? That is, after all, exactly what it does. the owners of the means of production pocket the surplus that accrues by dint of the competitive exchange rate while, at the same time, the public has less value in its pocket to buy goods because their currency is devalued. I'm sure some economist could make a better case than I could along these lines.

But the sticking point in China is obvious: I have never seen anybody with a stake in China criticize the government there. I'm sure one cannot criticize with impunity.

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9.

sacmac

malaysia

March 12th, 2010

2:29 pm

Is there an objective definition or rules in economics for one to check if a country is manipulating its currency? Are such rules or definition applicable to everyone as mandated by an international organisation such as WTO?

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10.

[Sean](#)

Florida

March 12th, 2010

2:29 pm

Remember. China already has a government that owns large swaths of economic activity. It is admired by Tom Friedman for its command-and-control politics. It is, in variant forms, the structure of the social democracies that Prof. Krugman admires (see his January 11, 2008 post). And yet --- it is not "doing the right thing." How could this be possible?

The answer comes if you set aside Krugmanist ideology, and recognizes that markets, regardless of their imperfections, produce better outcomes than political processes.

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11.

sacmac

malaysia

March 12th, 2010

2:29 pm

I suppose US is in "unemployment/deficit" sector. What are the political considerations preventing US from resolving its own problems? Could US's predicament be solved by just China adjusting its currency?

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[12.](#)

Mark

Crestwood, Kentucky

March 12th, 2010

2:29 pm

Since all that we are seeing from Washington is INACTION, the ONLY immediate impact to the U.S. economy resulting from China's inflation problem is that we will have to pay more for the wind turbines that we import from China for our "Stimulus Supported, Can't Be Outsourced" Green Energy Program.

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[13.](#)

[Lloyd Little](#)

Las Vegas

March 12th, 2010

2:30 pm

Dr. Krugman, given that this economy is now growing at the same time most Americans are reporting their personal fortunes are filled with stress. Do you think there is any tie between the relationship between China's export based growth, American Corporate Profits, and our woeful job data?

A relationship that would state free markets are not in play on either side of the Pacific?

Of course I ask this because if we are involved with a new form of Mercantilism, we might as well face it. Also, there seems to be a disconnect between much of the theory that has promoted free trade without recognizing the context in which it might take place. In fact, my concerns are whether or not free trade can be manipulated at the gov't level. In other words, can we use Gatt type treaties that undermine free trade, have we?

I do know this, while we've reported with great excitement that the service sector economy ushered in a more sophisticated economy...as we've deindustrialized, gotten rid of "smoke stacks"...still, between 90 - 98 manufactures accounted for over 50% of world GDP! Such a consequent misstatement of how the world "works" seems to be doing us no good. (well, many of us, anyway) So, again, I ask is such a state of affairs now locked in to the way the world economy operates?

Thanks!

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[14.](#)

Hal

Tucson, AZ

March 12th, 2010

2:30 pm

I read a while back that some important Chinese said they used to respect American economic advice, but that since the great recession they realized the emperor has no clothes and therefore don't pay much attention any more. So you can continue to give them advice; I doubt they will pay much attention.

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[15.](#)

ddf

Asia

March 12th, 2010

2:30 pm

The market consensus is wrong: China does not have a goods inflation problem. February mom inflation was 0.1% non sa. And most of the yoy inflation was caused by food prices up 6.2% in February. The weight of food in the CPI is .33% (tobacco and prepared food account for another 12%). Excluding food the February CPI was

up 1% yoy. On the goods markets, China's economy has a strong deflationary bias due to investment driven growth that creates structural excess capacity and to the continued migration of rural workers into higher productivity sectors (there are still more than 300 million workers in China's agricultural sector). China's inflationary bias is on the asset markets due to very high savings, especially corporate saving, an underdeveloped financial sector, and capital controls.

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16.

Dan Nile

Los Angeles

March 12th, 2010

2:30 pm

It's amusing how the Swan Diagram takes four variables that are at best loosely and non-linearly-correlated, leaps to a linearity assumption, and then you tell the Chinese that a "model" says they must appreciate their currency.

The "dismal science" indeed.

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17.

GarlicToast

Kansas

March 12th, 2010

2:30 pm

The US seems to be doing the opposite, over-consuming and under-investing. There's a very simple free-market way to improve our trade situation and also the federal budget. It is to raise taxes especially on high incomes and high wealth (cheer for the death tax!). Taxes divert money from what we call consumption to what we call investment. That's the reason for the Clinton boom and Bush's tax cuts & wars are a leading reason for the current bust. I wish someone would say it---normal-time deficits crowd out investment and do long-term damage to the job market and business prosperity.

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18.

GaUCHO

Los Angeles, CA

March 12th, 2010

2:30 pm

Unfortunately, it's not only political considerations, it's special interests too. A significant portion of "Chinese" exports are actually exports of US and European subsidiaries in China. significant renminbi appreciation will compress margins and hurt earnings.

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19.

Vanine

Rocklin, Ca

March 12th, 2010

2:30 pm

How about this objective for a country: Keep their citizens healthy, well fed, well educated, productive and safe? Why no economist talk or has a graph for THAT objective? Is it irrelevant?

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20.

CRO

Hong Kong

March 12th, 2010

2:30 pm

Not many would disagree with the call for an RMB appreciation under the current circumstances in China. However, one point is easily forgotten in this discussion: China is not a homogenous economic or political power. There are many regions at very different levels of economic developments, 50 odd ethnic minorities with more or less strong desires for political autonomy, different factions in the central government, and regional governments with a tendency to largely ignore the directives coming from Beijing. The primary goal of the Chinese government will be to sustain a strong domestic economy to support internal political stability at all cost. The political posturing of the US, shedding crocodile tears on their way to find someone to blame for their own economic misery is likely to be ignored by the Chinese. And we should be grateful for that. China has a long history of civil wars and internal unrests. God help us if such social unrests on a national scale would happen in the modern age, it would spell disaster for the rest of the world.

Let's not forget, China is the proof for the success of a government led stimulus policy, and the Chinese government will be very cautious to withdraw their stimulus measures (including letting the currency appreciate) too early. Yes, there are many challenges ahead for the Chinese policy makers: unsustainable imbalances between China and its debtors, export economy vulnerable to external shocks, overinvestments leading to overcapacity, excessive liquidity creating inflationary pressure, to name just a few. And the Chinese policy makers are conscious of the fact that they have to eventually let the currency appreciate, but it will not be done because of a memo from the US Treasury, but only because it is beneficial to the domestic economy, with a view to maintain internal stability.

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21.

DH

Orlando

March 12th, 2010

2:30 pm

But Tim Geithner already told us to our faces that China is not manipulating their currency. Who should I trust?

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22.

Brady

London

March 12th, 2010

2:30 pm

Come on Professor, name the last time that shaming China influenced their human rights, foreign, fiscal, or monetary policies.

If letting the renminbi appreciate is truly in the Chinese national interest, then our government is probably best off saying nothing, and letting them make the change without losing face.

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23.

Sean

chicago

March 12th, 2010

2:30 pm

I rarely agree with you finding you far too partisan, but yes we do need China to adjust their currency, their trade surpluses force the rest of the world to run deficits and have created our currently overleveraged global economy. They are "THE" systemic risks.

I can not decide if pressing them as a currency manipulator will do any good, I like the idea of it, but they seem stubborn and the harder the push the more they will hold back. Our best policy is the policy that gets them to drop the peg as soon as possible. We do have options, one option is to debase the currency to the extent that it causes them severe inflation to maintain the peg (we obviously take some pain too) or we could enact much



greater protectionism, neither are great ideas, but what do you do when a nation will not drop a peg to your currency (Which can be ok when it is a small economy but disastrous when it is a big country manipulating exchange rates)

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[24.](#)

Jack C

Melbourne, AUS

March 12th, 2010

2:30 pm

Raising interest rate and making Renminbi higher in value should always be domestic economy-oriented. There are dozens more countries in Asia particularly that are manipulating their currencies, why don't people target them? China is not really in a position to relax on their "crisis measures", with most of their economic growth last year depending on the stimulus package launched rather than their exporters. If they were to make changes to their Renminbi policy, they should be doing it in a more stable time, i.e. when there are less PIGS and Dubai around for there are still serious risks of sovereign insolvency worldwide.

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Denver Analytics

Denver

March 12th, 2010

2:30 pm

Professor Krugman has a gift to communicate in a concise manner that often misunderstood fact that the discipline of economics is complex and often nearly always a simulations and normative exercise. A key contributor to inflation is shadow money. The US has a very limited supply; thus inflation worries are diminished. China is awash in shadow money.

If we (individuals or countries) all possessed the privilege to arbitrarily create the value of our currency, think of how that would disrupt an economy.

I fully agree with Dr. Krugman's statement regarding USA Treasury intervention.

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Paul Krugman is an Op-Ed columnist for The New York Times.

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### Books

- [Principles of Economics, 2nd ed.](#) (2009)
- [The Return of Depression Economics and the Crisis of 2008](#) (Dec. 2008)
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