TheMoneyIllusion

A slightly off-center perspective on monetary problems.

Krugman's peculiar views on American nationalism and the Chinese yuan

This will be a long post, as Paul Krugman's recent piece on the yuan raises all sorts of different questions. Let's start with his assertion that an overvalued Chinese currency is restricting our ability to reflate our economy:

> But given our economy's desperate need for more jobs, a weaker dollar is very much in our national interest — and we can and should take action against countries that are keeping their currencies undervalued, and thereby standing in the way of a much-needed decline in our trade deficit.
>
> That, above all, means China.

But how do we know the yuan is undervalued? Its current value is not out of line with predictions of the Balassa-Samuelson Theorem, which predicts that countries with higher per capita GDPs will have higher real exchange rates. Krugman points to the huge Chinese trade surplus. But is their surplus actually all that large? After all, China is a very big country. As I pointed out earlier, the Germanic/Nordic current account surplus is vastly larger, despite the fact that the countries lying between Switzerland and Norway have a combined population only a tenth as large as China's. The smaller East Asian countries also have vastly bigger surpluses on a per capita basis. So why focus on China?

Another argument is that China's surplus is in some sense "unnatural," whereas the surplus of the Nordic bloc is natural, reflecting the decisions of the private sector. There are several problems with this argument. First, in all countries the level of savings is strongly influenced by fiscal policies. For instance, Sweden has no inheritance tax, whereas Austria and Germany have no capital gains taxes. These fiscal policies boost saving rates. Singapore forces its citizens to save a large fraction of their income. In contrast, China is a former communist country that lacks a sound social security system. It makes a lot of sense for the Chinese government to have a high level of saving, especially given their approaching demographic time bomb.

But what about the charge that China is a currency manipulator? Krugman's too smart for that argument, I recall he once acknowledged that the real problem was Chinese government saving. Indeed if the Chinese government continued to buy large quantities of foreign debt, the value of the yuan would stay "artificially" low, *even without a formal* *currency peg*. So the "problem," if there is a problem at all, is not fixed exchange rates, it's that some countries save too much. And for some odd reason Krugman adopts a stance that you'd expect from right-wingers—*private saving good, public saving bad*.

> Some observers question whether we really know that China's currency is undervalued. But they're kidding, right? The flip side of the manipulation that keeps China's currency undervalued is the accumulation of dollar reserves — and those reserves now amount to a cool $3.2 trillion.

BTW, Greg Mankiw offered a similar criticism of Fred Bergsten a few days ago.

Last year Paul Krugman made this observation about Switzerland (in criticism of one of my posts):

> Oh, and about the exchange rate: there's this persistent delusion that central banks can easily prevent their currencies from appreciating. As a corrective, look at Switzerland, where the central bank has intervened on a truly massive scale in an attempt to keep the franc from rising against the euro — and failed:

Later I showed that Krugman was wrong; Switzerland's policy didn't fail. Now his tune seems to have changed. Yes, I know some readers will point out there is no contradiction in the following, (and technically that's true), but Krugman's smart enough to know how most readers will interpret this:

> To get our trade deficit down, however, we need to make American products more competitive, which in practice means that we need the dollar's value to fall in terms of other currencies. Yes, some people will shriek about "debasing" the dollar. But sensible policy makers have long known that sometimes a weaker currency means a stronger economy, and have acted on that knowledge. Switzerland, for example, has intervened massively to keep the franc from getting too strong against the euro. Israel has intervened even more forcefully to weaken the shekel.

Yes, he doesn't say the massive intervention "succeeded," but it'd be a bit odd to argue for currency depreciation in the US by pointing to countries that tried to do currency depreciation, and "failed." BTW, the recent Swiss intervention has succeeded, so far.

What bothers me the most is Krugman's assertion that China is "standing in the way" of an increase in US aggregate demand. This makes the Chinese seem like some sort of enemy of the US, even though the private actions of those thrifty Nordics are doing us far more harm, according to Krugman's model. Even worse, it suggests that we are helpless victims, whereas even Krugman admits that the fundamental problem is that we don't use monetary and fiscal policy to boost our own aggregate demand (AD.) So the "harm" being done is only harmful if our policymakers ignore textbook advice to keep AD at an adequate level. Yes, we are ignoring that textbook advice, but I'm having trouble seeing how that's China's fault. Again, I'm not arguing that there is any logical inconsistency there, but I can't imagine that many of Krugman's readers will connect the dots as I have. Most will assume that China really is "standing in the way," not that we could offset any harm with the flip of a switch.

Even worse, Krugman's appealing to people who completely reject his AD-view of the recession, which these days isn't just Pat Buchanan, but rather 90% of the public, and 90% of the "Very Serious People." Don't believe me? Go ask around and see how many people think our unemployment problem could be solved with an increase in the inflation target to 4%.

Here's an especially odd juxtaposition:

> And the reality of the unemployment disaster is also my answer to those who warn that getting tough with China might unleash a trade war or damage world commercial diplomacy. Those are real risks, although I

> think they're exaggerated. But they need to be set against the fact — not the mere possibility — that high unemployment is inflicting tremendous cumulative damage as we speak.
>
> Ben Bernanke, the chairman of the Federal Reserve, said it clearly last week: unemployment is a "national crisis," with so many workers now among the long-term unemployed that the economy is at risk of suffering long-run as well as short-run damage.

China bashing helps, if it helps at all, by boosting AD. No one claims it boosts the supply-side of our economy. So Krugman cites Ben Bernanke in defense of the argument that we need more AD to reduce unemployment; even though Ben Bernanke is the guy that controls AD, and who defends current Fed policy as being appropriate, and who opposes higher inflation despite the fact that any attempt to boost AD (especially tariffs on Chinese goods) will mean higher inflation.

Perhaps in his heart of hearts Bernanke favors easier money. But people should be cited on the basis of their publicly expressed policy views. This may sound grotesque, but right now the Fed's publicly expressed policy is to keep inflation steady, which means they are officially committed to offsetting any boost to AD from more expensive Chinese imports. Good luck with trying an end run around the Fed (as I've been correctly warning since late 2008.)

Here's what we know:

1. An appreciation of the Chinese currency is contractionary for China, perhaps costing millions of jobs and slowing growth sharply, just as a strong yuan in 1998 sharply slowed Chinese growth.

2. Both China and the world seem to be teetering on the edge of another recession.

3. In March 2009 many observers, and many market participants, predicted a depression. Then China began to recovery rapidly, boosting world trade, and easing fears of an outright worldwide depression.

4. If the Fed follows its announced policy of inflation targeting, the contractionary effect of China's action on world output will not be offset by any expansionary effects on the US. Yes, they may not follow a strict inflation target, and hence it's *possible* the action will have some expansionary effect here. But the only effect that's certain is the contractionary effect in China.

5. If China went to a policy of complete laissez faire, it's possible (albeit unlikely) that so many Chinese would rush to get money out of the country, and into houses in Vancouver/LA/Sydney, that the yuan would depreciate. Especially if China does go into recession.

6. From a liberal utilitarian perspective, trade barriers on Chinese imports are completely unjustified, even if Krugman is 100% right in his analysis. Chinese workers are several orders of magnitude poorer than US workers, and our safety net seems almost Nordic in comparison to the Chinese safety net.

The most distressing aspect of Krugman's post is its nationalistic tone:

> . . . standing up for our national interests.

The worst mistake the world could make right now is to descend into nationalistic posturing. We can all see what's going on in Europe, and we all know how nationalism can end up hurting everyone. The last thing we should be doing right now is pointing fingers at foreigners.

We have the ability to solve our own AD problem; now we need to get on with doing it. If the Senate wants to do something constructive, give the Fed a mandate consistent with what the Senate wants the Fed to accomplish. If the

Senate wants more AD, don't try to take it out of the pockets of Chinese workers. Let's do it the way economics textbooks say it should be done, with Federal Reserve targeting of prices or NGDP.

Don't make policy based on zero sum thinking. The world needs growth, not trade wars.

HT: Clark Johnson

Tags:

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America's rich because we have lots of big houses »

55 Responses to "Krugman's peculiar views on American nationalism and the Chinese yuan"

1. K
   3. October 2011 at 09:38

   If China wants to play hedge fund, two can play at that game. The treasury should issue the bonds it needs to finance the deficit *plus* whatever excess demand the currency manipulators, oops, I mean *savers*, are creating. If China wants bonds, lets make them some! And the rest of the market also wants more bonds (negative beta). With a bit of luck, additional issuance will increase inflation expectations and bring the dollar back to equilibrium and get us underway. If and when that point comes around, treasury can make a big profit when they buy back those bonds at a discount. All we need is to get congress on board

2. W. Peden
   3. October 2011 at 09:39

   Good stuff, as always. A lot of people should be eating their words over Switzerland right now.

   On the subject of poking holes in Krugman's commentary-

   http://ritwikpriya.blogspot.com/2011/09/old-keynesian-deceit-crisis-europe.html

3. Brett Sheckler
   3. October 2011 at 09:41

   Great post, Scott.

   In a nutshell, it seems to me that you are arguing that, if countries want to support current account imbalances by