The New York Times

January 1, 2010

OP-ED COLUMNIST

Chinese New Year

By PAUL KRUGMAN

It's the season when pundits traditionally make predictions about the year ahead. Mine concerns international economics: I predict that 2010 will be the year of China. And not in a good way.

Actually, the biggest problems with China involve climate change. But today I want to focus on currency policy.

China has become a major financial and trade power. But it doesn't act like other big economies. Instead, it follows a mercantilist policy, keeping its trade surplus artificially high. And in today's depressed world, that policy is, to put it bluntly, predatory.

Here's how it works: Unlike the dollar, the euro or the yen, whose values fluctuate freely, China's currency is pegged by official policy at about 6.8 yuan to the dollar. At this exchange rate, Chinese manufacturing has a large cost advantage over its rivals, leading to huge trade surpluses.

Under normal circumstances, the inflow of dollars from those surpluses would push up the value of China's currency, unless it was offset by private investors heading the other way. And private investors are trying to get into China, not out of it. But China's government restricts capital inflows, even as it buys up dollars and parks them abroad, adding to a $2 trillion-plus hoard of foreign exchange reserves.

This policy is good for China's export-oriented state-industrial complex, not so good for Chinese consumers. But what about the rest of us?

In the past, China's accumulation of foreign reserves, many of which were invested in American bonds, was arguably doing us a favor by keeping interest rates low — although what we did with those low interest rates was mainly to inflate a housing bubble. But right now the world is awash in cheap money, looking for someplace to go. Short-term interest rates are close to zero; long-term interest rates are higher, but only because investors expect the zero-rate policy to end some day. China's bond purchases make little or no difference.

Meanwhile, that trade surplus drains much-needed demand away from a depressed world economy. My back-of-the-envelope calculations suggest that for the next couple of years Chinese mercantilism may end up reducing U.S. employment by around 1.4 million jobs.

The Chinese refuse to acknowledge the problem. Recently Wen Jiabao, the prime minister, dismissed foreign complaints: "On one hand, you are asking for the yuan to appreciate, and on the other hand, you are taking all kinds of protectionist measures." Indeed: other countries are taking (modest) protectionist measures precisely because China refuses to let its currency rise. And more such measures are entirely appropriate.

Or are they? I usually hear two reasons for not confronting China over its policies. Neither holds water.

First, there's the claim that we can't confront the Chinese because they would wreak havoc with the U.S. economy by dumping their hoard of dollars. This is all wrong, and not just because in so doing the Chinese would inflict large losses on themselves. The larger point is that the same forces that make Chinese mercantilism so damaging right now also mean that China has little or no financial leverage.

Again, right now the world is awash in cheap money. So if China were to start selling dollars, there's no reason to think it would significantly raise U.S. interest rates. It would probably weaken the dollar against other currencies — but that would be good, not bad, for U.S. competitiveness and employment. So if the Chinese do dump dollars, we should send them a thank-you note.

Second, there's the claim that protectionism is always a bad thing, in any circumstances. If that's what you believe, however, you learned Econ 101 from the wrong people — because when unemployment is high and the government can't restore full employment, the usual rules don't apply.

Let me quote from a classic paper by the late Paul Samuelson, who more or less created modern economics: "With employment less than full ... all the debunked mercantilistic arguments" — that is, claims that nations who subsidize their exports effectively steal jobs from other countries — "turn out to be valid." He then went on to argue that persistently misaligned exchange rates create "genuine problems for free-trade apologetics." The best answer to these problems is getting exchange rates back to where they ought to be. But that's exactly what China is refusing to let happen.

The bottom line is that Chinese mercantilism is a growing problem, and the victims of that mercantilism have little to lose from a trade confrontation. So I'd urge China's government to reconsider its stubbornness. Otherwise, the very mild protectionism it's currently complaining about will be the start of something much bigger.