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Krugman's Chinese renminbi fallacy

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Paul Krugman is one of the international economists I most respect. He is a towering figure in the study of international trade. But his understanding of some international economic policy issues is, to put it generously, naïve. In fact, were the Obama administration to follow his policy advice, the world economy could encounter more serious difficulties, if not another recession, in the years ahead.

In the year 2010, Krugman suddenly found a new and passionate interest in China's exchange rate policy. On 1 January, in his piece 'Chinese New Year' [1], Krugman claimed that America had lost 1.4 million jobs because of the undervalued renminbi and, therefore, he endorsed trade protectionism against China. On 11 March, in another piece, 'China's swan song [2]', he advised the Treasury Department to name China as a currency manipulator. And on 12 March, at an Economic Policy Institute [3] event, in Washington, he said that global economic growth would be about 1.5 percentage points higher if China stopped restraining the value of its currency and running a trade surplus.

Most economists would agree with Krugman that the renminbi is probably undervalued [4]. But the extent of misalignment remains a controversial subject. For instance, applying purchasing power parity (PPP) approach, Menzie Chinn of University of Wisconsin, Madison, and his collaborators used to discover undervaluation of about 40 per cent. But after the World Bank's 40 per cent downward revision of Chinese GDP in PPP terms, that undervaluation disappeared completely. Nick Lardy and Morris Goldstein of the Peterson Institute of International Economics suggested that renminbi was probably only undervalued by 12-16 per cent at the end of 2008. My colleague Yang Yao and his collaborator at the Peking University found even less misalignment.

The renminbi exchange rate is but one [5], and perhaps not even the most important, factor behind China's large trade and current account surpluses. Among other factors, economic studies have attributed the recent surge in China's external imbalances to the unique population dividend and the relocation of industries from other Asian economies. My own research has also highlighted the importance of distortions in domestic factor markets, which were largely legacies of the pre-reform economic systems of central planning.

To resolve the global imbalance problem, China, US and other countries will need to work together and adopt more comprehensive reform packages, focusing not only on the exchange rate regime but also on domestic structural reforms in their respective countries. Exclusive focus on the renminbi exchange rate issue is likely to be both ineffective and counter-productive [6]. Between mid-2005 and mid-2008, the renminbi appreciated by 22 per cent against US dollar and by 16 per cent in real effective terms. But China's external imbalances continued to widen rapidly.

The US started to lose manufacturing jobs way before China emerged as a global manufacturing centre. China's current account surplus increased after 2004. But America's current account deficits mushroomed from around the turn of the century. There is no denying that China and the US should work together to resolve the imbalance problem. But to say that China's surplus ***caused*** America's deficits, which emerged much earlier, is simply at odds with common sense.

So what would happen were the Obama administration to follow Krugman's advice? First of all, it would delay, not accelerate China's exchange rate policy reform. On 6 March, the People's Bank of China (PBOC) Governor Zhou Xiaochuan made it clear that the current soft peg of renminbi to the US dollar was a temporary response to the global financial crisis and that this would have to end. These statements clearly suggest that the Chinese authorities are searching for an appropriate time for exit from the soft peg and I think this could happen any moment from now.

But finding the appropriate time is not always easy. The China-US policy game on renminbi exchange rate can be best characterised as a 'prisoners' dilemma'. It is important to keep in mind that, like American politicians, Chinese leaders also have to entertain domestic political pressure. And to be seen as giving in to American pressure can substantially weaken the leaders' political standing and capacity to act in everyone's best interests. China is more likely to move ahead quickly if the US maintains a calm and rational stance. This was largely what happened in the lead up to the July 2005 exchange rate reform.

But the prisoners' dilemma arises here. American politicians and commentators will not want to keep quiet since that will lose them the opportunity to take political credit, even if China liberalises the exchange rate policy. In fact, some American politicians may be secretly hoping that China does not do anything. Many of them understand perfectly well that revaluation of renminbi will not bring jobs back to the US If that happens, then they will have to find a new scapegoat for the double digit unemployment problem. In the meantime, the Chinese government is reluctant to make any significant change under foreign pressure. This is why Krugman's intervention only makes things worse.

Let's imagine some scenarios in which Krugman gets what he asks for: the US Treasury Department names China as a currency manipulator and the Obama administration launches trade war against China. If this were to happen, the most likely scenario is that China would then stick to its current exchange rate regime and retaliate with trade sanctions against America. This would reduce trade between the two countries but, more importantly, seriously damage investor confidence worldwide. Trade war between the two largest economies is a non-trivial event for the world economy. In face of much more uncertain economic future, investors would scale back their investment plans and consumers would cut back their spending.

A less likely scenario is that China would be forced to appreciate the currency sharply by, say, 40 per cent. This is likely to cause significant difficulties for Chinese companies if the exchange rate adjustment were forced abruptly. Again, there could be two possible outcomes. The first is that Chinese companies would no longer be able to export because of sudden loss of competitiveness. The market vacuum newly made available by exit of Chinese products would be taken up by products from other low-cost countries like Vietnam and India. American companies would not be able to compete with these countries. So this would not add new jobs in the US, but the inflation rate would move higher.

Since exports account for more than one-third of the Chinese economy, collapse of exports would cause serious difficulties for China. Chinese growth would decelerate sharply, as happened in late 2008. This would be unfortunate since most major economies are still struggling with recovery. And sudden weakening of the world's most dynamic economy would send chilling messages across the world markets. Investor confidence would again fall sharply.

The second possible outcome is that China would continue to export to the US market, at higher prices but lower profits. This would push up inflation rates significantly in the US and force the Fed to tighten monetary policy quickly. Both steps could hurt the momentum of America's recovery, which is still not yet on steady footing. New difficulties in the US and China, the two largest economies of the world, would impact global investor confidence negatively.

In either case, global economic growth would be about 1.5 percentage points lower, not higher, if China revalued the currency as Krugman demands. The magnitude is probably exaggerated, but the direction is certain.

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[1] 'Chinese New Year': **http://www.nytimes.com/2010/01/01/opinion/01krugman.html**

[2] China's swan song: **http://krugman.blogs.nytimes.com/2010/03/11/chinas-swan-song/**

[3] Economic Policy Institute: **http://www.businessweek.com/news/2010-03-12/krugman-says-china-yuan-policy-depresses-global-economic-growth.html**

[4] probably undervalued: **http://www.eastasiaforum.org/2010/02/09/the-china-syndrome-on-exchange-rates/**

[5] but one: **http://www.eastasiaforum.org/2009/12/13/fixing-chinas-current-account-surplus/**

[6] ineffective and counter-productive: **http://www.eastasiaforum.org/2010/02/23/us-china-economic-imbalance-alternatives-to-appreciating-the-chinese-yuan/**

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