The New York Times

March 15, 2010

OP-ED COLUMNIST

Taking On China

By PAUL KRUGMAN

Tensions are rising over Chinese economic policy, and rightly so: China's policy of keeping its currency, the renminbi, undervalued has become a significant drag on global economic recovery. Something must be done.

To give you a sense of the problem: Widespread complaints that China was manipulating its currency — selling renminbi and buying foreign currencies, so as to keep the renminbi weak and China's exports artificially competitive — began around 2003. At that point China was adding about $10 billion a month to its reserves, and in 2003 it ran an overall surplus on its current account — a broad measure of the trade balance — of $46 billion.

Today, China is adding more than $30 billion a month to its $2.4 trillion hoard of reserves. The International Monetary Fund expects China to have a 2010 current surplus of more than $450 billion — 10 times the 2003 figure. This is the most distortionary exchange rate policy any major nation has ever followed.

And it's a policy that seriously damages the rest of the world. Most of the world's large economies are stuck in a liquidity trap — deeply depressed, but unable to generate a recovery by cutting interest rates because the relevant rates are already near zero. China, by engineering an unwarranted trade surplus, is in effect imposing an anti-stimulus on these economies, which they can't offset.

So how should we respond? First of all, the U.S. Treasury Department must stop fudging and obfuscating.

Twice a year, by law, Treasury must issue a report identifying nations that "manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." The law's intent is clear: the report should be a factual determination, not a policy statement. In practice, however, Treasury has been both unwilling to take action on the renminbi and unwilling to do what the law requires, namely explain to Congress why it isn't taking action. Instead, it has spent the past six or seven years pretending not to see the obvious.

Will the next report, due April 15, continue this tradition? Stay tuned.

If Treasury does find Chinese currency manipulation, then what? Here, we have to get past a common misunderstanding: the view that the Chinese have us over a barrel, because we don't dare provoke China into dumping its dollar assets.

What you have to ask is, What would happen if China tried to sell a large share of its U.S. assets? Would interest rates soar? Short-term U.S. interest rates wouldn't change: they're being kept near zero by the Fed, which won't raise rates until the unemployment rate comes down. Long-term rates might rise slightly, but they're mainly determined by market expectations of future short-term rates. Also, the Fed could offset any interest-rate impact of a Chinese pullback by expanding its own purchases of long-term bonds.

It's true that if China dumped its U.S. assets the value of the dollar would fall against other major currencies, such as the euro. But that would be a good thing for the United States, since it would make our goods more competitive and reduce our trade deficit. On the other hand, it would be a bad thing for China, which would suffer large losses on its dollar holdings. In short, right now America has China over a barrel, not the other way around.

So we have no reason to fear China. But what should we do?

Some still argue that we must reason gently with China, not confront it. But we've been reasoning with China for years, as its surplus ballooned, and gotten nowhere: on Sunday Wen Jiabao, the Chinese prime minister, declared — absurdly — that his nation's currency is not undervalued. (The Peterson Institute for International Economics estimates that the renminbi is undervalued by between 20 and 40 percent.) And Mr. Wen accused other nations of doing what China actually does, seeking to weaken their currencies "just for the purposes of increasing their own exports."

But if sweet reason won't work, what's the alternative? In 1971 the United States dealt with a similar but much less severe problem of foreign undervaluation by imposing a temporary 10 percent surcharge on imports, which was removed a few months later after Germany, Japan and other nations raised the dollar value of their currencies. At this point, it's hard to see China changing its policies unless faced with the threat of similar action — except that this time the surcharge would have to be much larger, say 25 percent.

I don't propose this turn to policy hardball lightly. But Chinese currency policy is adding materially to the world's economic problems at a time when those problems are already very severe. It's time to take a stand.