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# *A Reply* To Krugman

*In a recent column, Nobel Prize-winning columnist Paul Krugman accused China of mercantilism. Stanford Professor Ron McKinnon offers a spirited rebuttal.*

## What Manipulation?

I am dismayed but not surprised by Paul Krugman's China bashing. Among economists but probably few others, to label a country as "mercantilist" as Krugman does is as vituperative as you can get—at least since the days of Adam Smith who gave mercantilists such a bad time in *The Wealth of Nations.*

China has not been deliberately undervaluing the RMB to gain a mercantile advantage. Rather, it has been searching for exchange-rate and price-level stability in a world which, for better or for worse, is largely on a dollar standard. From 1995 to 2005, China fully fixed its exchange rate at 8.28 yuan/dollar as an anchor against its high inflation in 1993–95. And with this anchor, China's internal inflation slowed down to the American rate. Unlike its Asian neighbors, it did not devalue in the great Asian crisis of 1997–98—thus saving them from an even more catastrophic downturn

Over the past decade, what then accounts for the increases in China's trade surplus and the even larger U.S. trade deficit? Since 2000, the American national saving rate—personal plus government—unexpectedly fell sharply, and China's net national saving rose from unexpectedly robust enterprise profits and a surge in tax revenue (with no increase in tax rates). From this large international saving imbalance, the stage was set for a large Chinese trade surplus as the counterpart of America's trade deficit.

However, the trade imbalance is a net saving imbalance, and not an exchange rate issue. Any precipitate appreciation of the RMB could well have the perverse effect of increasing China's trade surplus! As a simple accounting identity, an economy's net saving (trade surplus) is simply the difference between domestic gross saving and domestic investment. A discrete appreciation of the RMB would have only an ambiguous effect

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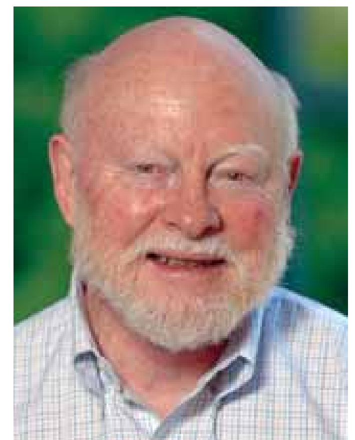


Ronald McKinnon

**McKinnon,** *continued from page 37*

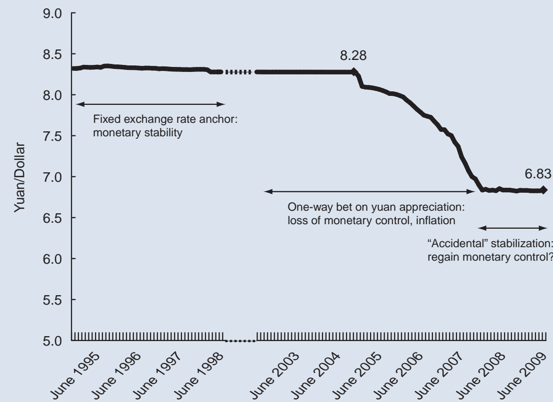
on China's domestic saving, but investment would certainly slump as national and multinational firms see China as a more expensive place in which to produce. Whence the possible perverse rise in China's trade surplus.

Unfortunately, by misinterpreting the trade imbalance as evidence of a misaligned exchange rate, Krugman and many other economists prevailed on the U.S. government to threaten tariffs on Chinese exports to the United States unless China appreciated the RMB. Giving into this pressure in July 2005, China started appreciating the RMB at about 6 percent per year (Figure 1). Unsurprisingly, with this one-way bet on the RMB going ever higher, hot money poured into China with no natural private capital outflows to finance the large trade surplus. The government was forced to intervene and buy dollars to prevent the RMB from spiraling upward. But despite massive sterilization efforts, the huge increase in official exchange reserves and base money threatened a loss of monetary control with inflation. China's trade (saving) surplus got even bigger.

Then a "lucky" accident happened. In the global credit crunch, the dollar suddenly shot up in the last half of 2008 against most other currencies (Figure 2)—including a 25 percent appreciation against the euro—and carried the RMB with it. With the RMB (and dollar) much higher against the currencies of most other countries, the People's Bank of China was emboldened to stop appreciating against the dollar: In July 2008, it reset the rate at 6.83 yuan per dollar where it remains today (Figure 1).

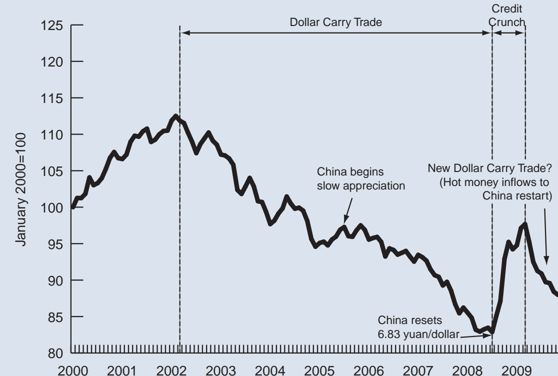
This newly stabilized rate was credible for nine or ten months into mid-2009: hot money inflows to China stopped and some private capital flowed out. Most importantly, the government could now safely promote a massive internal expansion of bank credit by cutting the reserve requirements on the commercial banks and loosening direct restrictions on bank credit. China's bank-financed "fiscal" stimulus was hugely successful. In the global downturn, the increase in China's domestic demand has largely offset the 40 percent fall in China's exports. Neighboring countries, particularly in Asia but also with echo effects in the United States and Europe, have benefited enormously. China's domestic demand (not exports) has been the engine of the surprisingly fast worldwide recovery from the global credit crunch of 2008. But it would not have been possible without the stabilization of the yuan/dollar rate, which Professor Krugman decries as "mercantilism."

**Fig. 1 China's monetary policy and the yuan/dollar rate**




Source: Federal Reserve economic data

**Fig. 2 The U.S. dollar's exchange rate movements**




Source: Federal Reserve economic data

A sad footnote to this otherwise encouraging story is the depreciation of the dollar since March 2009 (about 15 percent against the euro) which, of course, incidentally carried the RMB down with it. Again a Greek chorus of economists is complaining about China deliberately undervaluing its currency—and hot money inflows into China have started up again (Figure 2) in anticipation of another possible RMB appreciation. But this is a problem with America's ultra-loose monetary policy which has the "mercantilist" effect of overvaluing floating currencies such as the yen and euro. However, an analysis of the unfortunate domestic and international effects of the Fed setting short-term interest rates at zero is a story for another time. ◆