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Sent: 10/24/2009 4:21:49 PM +00:00

To: H <FIRST ORGANIZATION/EXCHANGE ADMINISTRATIVE GROUP (FYDIBOHF23SPDLT)/RECIPIENTS/HD R22>

Subject: in case you didn't read Krugman on the China problem... Sid

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October 23, 2009
Op-Ed Columnist

The Chinese Disconnect

By PAUL KRUGMAN

Senior monetary officials usually talk in code. So when Ben Bernanke, the Federal Reserve chairman, spoke recently about Asia, international imbalances and the financial crisis, he didn't specifically criticize China's outrageous currency policy.

But he didn't have to: everyone got the subtext. China's bad behavior is posing a growing threat to the rest of the world economy. The only question now is what the world — and, in particular, the United States — will do about it.

Some background: The value of China's currency, unlike, say, the value of the British pound, isn't determined by supply and demand. Instead, Chinese authorities enforced that target by buying or selling their currency in the foreign exchange market — a policy made possible by restrictions on the ability of private investors to move their money either into or out of the country.

There's nothing necessarily wrong with such a policy, especially in a still poor country whose financial system might all too easily be destabilized by volatile flows of hot money. In fact, the system served China well during the Asian financial crisis of the late 1990s. The crucial question, however, is whether the target value of the yuan is reasonable.

Until around 2001, you could argue that it was: China's overall trade position wasn't too far out of balance. From then onward, however, the policy of keeping the yuan-dollar rate fixed came to look increasingly bizarre. First of all, the dollar slid in value, especially against the euro, so that by keeping the yuan/dollar rate fixed, Chinese officials were, in effect, devaluing their currency against everyone else's. Meanwhile, productivity in China's export industries soared; combined with the de facto devaluation, this made Chinese goods extremely cheap on world markets.

The result was a huge Chinese trade surplus. If supply and demand had been allowed to prevail, the value of China's currency would have risen sharply. But Chinese authorities didn't let it rise. They kept it down by selling vast quantities of the currency, acquiring in return an enormous hoard of foreign assets, mostly in dollars, currently worth about $2.1 trillion.

Many economists, myself included, believe that China's asset-buying spree helped inflate the housing bubble, setting the stage for the global financial crisis. But China's insistence on keeping the yuan/dollar rate fixed, even when the dollar declines, may be doing even more harm now.

Although there has been a lot of doomsaying about the falling dollar, that decline is actually both natural and desirable. America needs a weaker dollar to help reduce its trade deficit, and it's getting that weaker dollar as nervous investors, who flocked into the presumed safety of U.S. debt at the peak of the crisis, have started putting their money to work elsewhere.

But China has been keeping its currency pegged to the dollar — which means that a country with a huge trade surplus and a rapidly recovering economy, a country whose currency should be rising in value, is in effect engineering a large devaluation instead.

And that's a particularly bad thing to do at a time when the world economy remains deeply depressed due to inadequate overall demand. By pursuing a weak-currency policy, China is siphoning some of that inadequate demand away from other nations, which is hurting growth almost everywhere. The biggest victims, by the way, are probably workers in other poor countries. In normal times, I'd be among the first to reject claims that China is stealing other peoples' jobs, but right now it's the simple truth.

So what are we going to do?

U.S. officials have been extremely cautious about confronting the China problem, to such an extent that last week the Treasury Department, while expressing "concerns," certified in a required report to Congress that China is not — repeat not — manipulating its currency. They're kidding, right?

The thing is, right now this caution makes little sense. Suppose the Chinese were to do what Wall Street and Washington seem to fear and start selling some of their dollar hoard. Under current conditions, this would actually help the U.S. economy by making our exports more competitive.

In fact, some countries, most notably Switzerland, have been trying to support their economies by selling their own currencies on the foreign exchange market. The United States, mainly for diplomatic reasons, can't do this; but if the Chinese decide to do it on our behalf, we should send them a thank-you note.

The point is that with the world economy still in a precarious state, beggar-thy-neighbor policies by major players can't be tolerated. Something must be done about China's currency.
