The Corner

Krugman's Risk Aversion (or Lack Thereof)

By Stephen Spruiell

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Since I have a big review of Paul Krugman's non-academic writing up on the home page today, I should probably comment on his latest entry into that body of work. Over the past year or so, Krugman has grown increasingly in favor of amping up our government's confrontation with China over its foreign-exchange-rate policy. As far as I can tell, Krugman would like to see the Senate pass, and the president sign and implement, the bill that passed the House last month, which would result in the imposition of high tariffs on everything we import from China. The editors did a fair job of explaining why this policy would really have no good outcome for the United States:

> A crackdown on China would be a full-employment plan for other developing countries: Unless we hit them all with tariffs, it would probably not create a single low-skilled job here. It might destroy a few, however, as retailers would be forced to make costly adjustments and establish new lines of trade with Vietnam and Bangladesh. How about exports? Here the case is a bit more plausible, but only a bit: Demand for the kind of high-value-added manufactured products that the Chinese buy from us — airplanes from Boeing, construction equipment from Caterpillar — will not be much affected. The manufacturers of those products are much more worried about the possibility of a trade war with China than they are about the value of the renminbi: Just ask them.
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> Meanwhile, the effects of actually enacting sweeping tariffs on Chinese imports are unknowable: If China decided to defy the sanctions and refused to let its exchange rate float, then we suspect the Chinese government would impose retaliatory countermeasures, leading to widespread layoffs at the aforementioned U.S. exporting concerns. If, on the other hand, China succumbed to the pressure to let its currency appreciate, then its own export-oriented businesses would be forced to cut back as they lost business to manufacturers in other low-wage countries. It's hard to imagine that the consequences for China — social upheaval, economic ruin, and rampant speculation as financiers took advantage of the suddenly floating exchange rate — would be good for a United States interested in international economic accord and global stability. The consequences could be more pedestrian, though contrary to the intentions of Congress: The Cato Institute's Dan Ikenson has pointed out that the Chinese let the renminbi appreciate by over 20 percent between 2005 and 2008, and the U.S. trade deficit with China continued to increase.
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> All this is to say nothing of what might happen to the other side of the equation: What happens to long-term interest rates if China stops lending us our own money back?

Krugman's column today illustrates his argument for sanctions against China by using the example of rare-earth materials, on which the Chinese have acquired a quasi-monopoly:

> Some background: The rare earths are elements whose unique properties play a crucial role in applications ranging from hybrid motors to fiber optics. Until the mid-1980s the United States dominated production, but then China moved in.
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> "There is oil in the Middle East; there is rare earth in China," declared Deng Xiaoping, the architect of China's economic transformation, in 1992. Indeed, China has about a third of the world's rare earth deposits. This relative abundance, combined with low extraction and processing costs — reflecting both low wages and weak environmental standards — allowed China's producers to undercut the U.S. industry.

Do note that, according to Krugman himself, China's "low wages and weak environmental standards," and not its foreign-exchange-rate policy, are what give it an advantage in the extraction and processing of rare earths. I submit that if one were to substitute "low-value-added manufacturing" for "rare-earth extraction and processing" in that narrative, then the narrative would still be true, yet it would illustrate a very different argument about China's foreign-exchange-rate policy and whether it causes much unemployment in the United States.

This isn't to say that China's foreign-exchange-rate policy has no adverse consequences: To the contrary, it encourages over-consumption and over-indebtedness in the United States and it isn't exactly great for working-class Chinese, either. It isn't a pressing matter, but we can't remain perched atop such an imbalance indefinitely. The question is whether we want to have a soft landing or a hard one. From 2005 to 2008, the Chinese let the renminbi appreciate gradually (from 8-to-1 to around 6.8-to-1); this is the kind of slow drift we need if we would prefer to avoid an abrupt, headfirst docking with the concrete. If, however, we would like to bring about the sort of mutually-assured-financial-destruction that a hard landing would entail, well, a good way to do that would be to take Krugman's advice and be as aggressively protectionist and undiplomatic toward the Chinese as possible. Let's lend some ammo to the Chinese hard-liners. Let's smack the American consumer around by jacking up the prices he pays for a whole range of products. Let's provoke our biggest foreign creditor — that big fiscal crisis snorting and pawing the ground over there doesn't look angry enough.

Krugman is very confident in his policy prescriptions and doesn't seem to worry at all about the consequences of his being wrong. We should be very glad that the Obama administration is, even in all its overreaching, just a tad more risk-averse.

Update: P.S. Do read Tom Maguire, Derek Scissors and Ryan Avent on the rare-earths question, and James Fallows on all of this recent exchange-rate stuff.

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