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KRUGMAN'S OPIUM WAR ON CHINA

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Paul Krugman's article *The Renminbi Runaround* in the June 24th edition of The New York Times is not only diplomatically insensitive: it also lacks economic justification. The United States, with its unprecedented debt, is hardly in a position to lecture China and accuse it of bad behavior, acting in bad faith, playing games, and threaten it with trade sanctions. It is not China's house that needs to be put in order, but that of the U.S.

Krugman assumes that the regime of flexible exchange rates is the nature-ordained foundation of foreign trade. It is not. It is a half-baked concoction, originally inspired by John Maynard Keynes, elevated to dogma by Milton Friedman. This regime has never been tried as a world-wide arrangement in all history, and when it was adopted in 1971, it turned out to be an unmitigated disaster. It did not grow naturally, nor was it the result of careful study and planning by competent scientists. It was a stop-gap measure imposed on the world unilaterally by American diktat in an attempt to cover up the disgrace of the U.S. declaring bankruptcy fraudulently while defaulting on its gold obligations to foreign governments.

Friedman asserted, wrongly, that variable foreign exchange rates would eliminate trade imbalances. As the currency of the surplus country appreciates, exports are discouraged while imports are encouraged. Conversely, as the currency of the deficit country depreciates, exports are encouraged while imports are discouraged. This forces adjustments in the volume of imports and exports that will continue until trade balance is restored.

The equilibrating effect of exchange rates on imports and exports is, at best, ephemeral. It may last as long as the inventory of ingredients that go into the exports of the deficit country does. But no sooner had these inventories been exhausted and needed replenishing than euphoria came to an abrupt end. As a direct consequence of the lower value of the currency of the deficit country, its terms of trade deteriorates, while that of the surplus country improves. In particular, the deficit country has the disadvantage of paying higher, while the surplus country has the advantage of paying lower prices for the imported components that go into their respective exports. The competitiveness of the deficit country suffers a further setback. Rather than working towards equilibrium, the floating exchange rate regime works towards perpetuating imbalances, nay, making them progressively worse. It throws the deficit countries into a vicious downward spiral from which it is ever more difficult to escape.

History bears out these theoretical observations. Thirty-five years ago it was Japan that the U.S. was lecturing to revalue its currency upwards. At the time one dollar fetched over 300 yens. During the intervening decades the dollar has duly been made weaker to the point that now the dollar fetches less than 100 yens. That is to say, the yen has appreciated more than threefold against the dollar. And what happened to the trade deficit of the U.S. *vis-a-vis*

Japan? Sad to say, rather than approaching equilibrium, it has worsened tenfold! Well, how much more beating down must the dollar take for the Friedman-mechanism to kick in?

In putting pressure on China to follow Japan's example to revalue the renminbi upwards, Krugman acts disingenuously. In effect he demands that China take a loss to the tune of hundreds of billions of renminbi units on its foreign currency reserves. Remember, China carries its books in renminbi, not in dollars. Consequently every loss in the value of the dollar in terms of the renminbi generates an immediate loss in the value of China's dollar reserves at the same rate.

To put it differently, Krugman demands that China grant the U.S. a unilateral abatement of debt. The question arises on what grounds can a country, chronically in deficit, and with a history of defaulting on its international obligations, demand an abatement of its debt?

If China yielded to American pressures and let the renminbi float upwards against the dollar, then it would be not just a one-shot abatement of the U.S. debt, but a commitment to grant further and automatic abatements as new debts are being incurred. It would invite further reckless debt-accumulation. It would make mockery out of the idea of independent nations trading with one another for mutual benefit. It would make China a vassal of the U.S., a role China, in all dignity, will never accept. Self-respecting sovereign nations cannot yield to pressures of this kind.

It is incumbent upon the debtor, not on the creditor, to mend ways in case of a persistent disequilibrium. Krugman went wrong as he embraced the Keynesian fallacy that the responsibility for restoring equilibrium rests, not with the debtors but with the creditors. This puts logic upside down as it penalizes hard work and thrift while rewarding indolence and prodigality.

Characteristically, the thought of fixed foreign exchange rates has never crossed Krugman's mind as the proper solution to America's and the world's trade woes. The regime of fixed exchange rates made America great, prosperous, and the envy of the world for centuries. The regime of floating exchange rates has frittered away the accumulated wealth and goodwill, as it has reduced America, in hardly a decade, from the greatest creditor to the greatest debtor nation of the world. To add insult to injury, it has made the dollar a chronically depreciating currency with the result that the American standard of living is now falling along with the dollar. The falling dollar has opened America to endless humiliation as it is fast losing the respect of other nations it once had.

Regardless how the trade dispute with China is going to be settled, continued reliance on the regime of floating exchange rates will lead to catastrophe. The world will succumb to trade war and a depression far worse than that of the 1930's, precisely because it lacks a valid equilibrating mechanism for world trade and it allows deficits to accumulate without limit. In view of looming trade wars, Krugman's aggressive threatening of China with sanctions on the eve of the G-20 meeting in Toronto is irresponsible, to say the least.

The regime of floating exchange rates is the opium of the world trade. Krugman wants the U.S. government to declare a new opium war on China to force this debilitating drug on the Chinese. If he succeeds, this time around it is not China that will end up on the losing side.

Calendar of Events

August 9-20, 2010, in Budapest, Hungary. The New Austrian School of Economics, the first 20-lecture course offered, entitled: *Disorder and Coordination in Economics — Has the world reached the ultimate economic and monetary disorder?* For more information, see the website www.professorfekete.com or contact szepesvari17@gmail.com

Preliminary announcement: a session in Hong Kong in late October is on the drawing board, followed by more events in New Zealand in November. Stay tuned.