America’s China Bashing: A Compendium of Junk Economics

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It is traditional for politicians to blame foreigners for problems that their own policies have caused. And in today’s zero-sum economies, it seems that if America is losing leadership position, other nations must be the beneficiaries. Inasmuch as China has avoided the financial overhead that has painted other economies into a corner, nationalistic U.S. politicians and journalists are blaming it for America’s declining economic power. I realize that balance-of-payments accounting and international trade theory are arcane topics, but I promise that by the time you finish this article, you will understand more than 99% of U.S. economists and diplomats striking this self-righteous pose.

The dollar’s double standard gives America an international free ride

For over a century, central banks have managed exchange rates by raising or lowering the interest rate. Countries running trade and payments deficits raise rate to attract foreign funds. The IMF also directs them to impose domestic austerity programs that reduce asset prices for their real estate, stocks and bonds, making them prone to foreign buyouts. Vulture investors and speculators usually have a field day, as they did in the Asian crisis of 1997.

Conversely, low interest rates lead bankers and speculators to seek higher returns abroad, borrowing domestic currency to buy foreign securities or make foreign loans. This capital outflow lowers the exchange rate.

There is a major exception, of course: the United States. Despite running the world’s largest balance-of-payments deficit and also the largest domestic government budget deficit, it has the world’s lowest interest rates and easiest credit. The Federal Reserve has depressed the dollar’s exchange rate by providing nearly free credit to banks at only 0.25% interest. This “quantitative easing” (making it easier to borrow more) aims at preventing U.S. real estate, stocks and bonds from falling further in price. The idea is to save banks from more defaults as the economy slips deeper into negative equity territory. A byproduct of this easy credit is to lower the dollar’s exchange rate – presumably helping U.S. exporters while forcing foreign producers either to raise the dollar price of their goods they sell here or absorb a currency loss.

This policy makes the dollar a managed currency. Low U.S. interest rates and easy credit spur investors to lend abroad or buy foreign assets yielding more than 1%. This dollar outflow forces other countries to protect *their* currencies from being forced up. So their central banks do not throw the excess dollars they receive onto the “free market,” but keep them in dollar form by buying U.S. Government bonds. So the “Chinese savings,” “yen savings” and “Euro savings” that are spent on U.S. Treasury securities (and earlier, on Fannie Mae bonds to earn a bit more) are not really what Chinese people save in their local yuan, or what Japanese or Europeans save. **The money used to buy U.S. Government securities consists of the excess dollars that the American military, American investors and American consumers spend abroad in excess of U.S. earning power**. To pretend that these savings are “saved up” by foreigners (who save in their own currency, after all) is Junk Economics Error #1.

By lowering U.S. interest rates to near zero, the U.S. Federal Reserve is doing what the Bank of Japan did after its financial bubble burst in 1990, when it helped Japanese banks “earn their way out of negative equity” by providing cheap credit to obtain a markup by lending to speculators and arbitrageurs to buy foreign bonds paying higher rates. This came to be known as the “carry trade.” Arbitrageurs borrowed yen cheaply and converted them into Euros, dollars, Icelandic kroner or other currencies paying a higher rate, pocketing the difference. This threw yen onto foreign-exchange market, weakening the exchange rate and hence helping Japanese automotive and electronics exporters.

This is the easy credit policy that the Fed is following today. U.S. banks borrow from the Federal Reserve at 0.25%, and lend to speculators at a markup of one or two percentage points. These speculators then look for companies, government bonds, corporate stocks and bonds and any other asset in a foreign currency that they believe may yield more than about 2% (or that are denominated in currencies that may raise in price against the dollar by more than 2% annually), hoping to pocket the difference.

Accusations that Japan, South Korea and Taiwan are “making their currencies cheaper” by recycling their dollar inflows into U.S. Treasury securities simply means that they are trying to maintain their currencies at a stable level. Even so, the yen’s exchange rate has risen as international borrowers pay off their carry-trade debts by re-converting the Euros, dollars and other currencies they borrowed in yen to play the arbitrage game. Paying back these foreign currency loans raises the yen’s price. To prevent this from pricing Japanese exporters out of world markets, Japan’s central bank is trying to stabilize the yen/dollar exchange rate by recycling these payments into the purchase of U.S. Treasury securities – exactly what U.S. officials accuse China of doing. **It is how most central banks throughout the world are responding to the global dollar glut. They are increasing their international reserves by the amount of surplus free credit” dollars that the U.S. payments deficit is pumping out.** To pretend that China is “manipulating its currency” by doing what central banks have done for over a century is Junk Economics Error #2. Back in the early 1970s, U.S. officials told OPEC governments that if they did not do this, it would be deemed an act of war. And Congress has refused to let China buy U.S. companies – so China can only recycle its dollar inflows by buying Treasury securities, thereby financing the U.S. federal budget deficit.

Every currency is managed by recycling dollars to avoid distorted exchange rates

To pretend that exchange rates are determined mainly by international trade is Junk Economics Error #3. International currency speculation and investment is much larger than the volume of commodity trade. The typical currency bet lasts less than a minute, often being computer-driven by arbitrage swap models. This financial fibrillation has dislodged exchange rates from purchasing-power parity or prices for export and imports.

The largest payments imbalances have little to do with "market forces" for imports and exports. They are what economists call price-inelastic – money spent without regard for price. This is true above all for military spending and maintenance of America's vast network of foreign bases and political maneuverings to control foreign countries. During the 1960s and '70s U.S. military spending accounted for the entire balance-of-payments deficit, as private sector trade and investment remained in balance. Escalation of America's oil war in the Near East and Pipelinistan, and the hundreds of billions of dollars spent to prop up America-friendly regimes, end up in central banks – whose main option, as noted above, is to send them back to the United States in the form of purchases of U.S. Treasury bills – to finance further federal deficit spending!

None of this can be blamed on China. But any nation that succeeds economically is assumed to be doing so at America's expense if they do not let U.S. investors siphon off the entire surplus. This attitude that other countries should sacrifice themselves is sweeping Congress, whose China bashing is reminiscent of the Japan-phobia of the late 1980s. The United States convinced the Bank of Japan to raise the yen's exchange rate in the 1985 Plaza Accord, and then to turn Japan into a bubble economy by flooding it with credit under the 1987 Louvre Accord. Tokyo was humorously referred to as "the 13th Federal Reserve district" for recycling its export earnings in U.S. Treasury bills, becoming the mainstay of the Reagan-Bush budget deficits that financed U.S. global military spending while quadrupling the public debt.

U.S. strategists would not mind seeing China's economy similarly untracked by letting global speculators bid up the renminbi's exchange rate – by enough to let Wall Street speculators make hundreds of billions of dollars betting on the run-up. "Free capital markets" and "open financial markets" are euphemisms for setting the renminbi's exchange rate by U.S. and European currency arbitrage and capital flight. The U.S. balance-of-payments outflow would increase rather than shrink, thanks to the ability of American banks to create nearly "free" credit on their keyboards to convert into Chinese or other currencies, gold or other speculative vehicles that look to rise against the dollar.

"In a world awash with excess savings, we don't need China's money," writes Prof. Krugman.[1] After all, "the Federal Reserve could and should buy up any bonds the Chinese sell." It's all just electronic credit. From reading such diatribes, or President Obama's exchange with Prime Minister Wen Jiabao at the United Nations on September 23, one would not realize that Chinese savers have not sent a single yuan of their own money to the United States.

But that is the point! Mr. Krugman should have reminded his readers that the balance of payments consists of much more than just the trade balance in today's world swamped by financial speculation and military spending. What China "invests" in the United States are the dollars thrown off by the U.S. payments deficit. China would take a loss on the yuan-value of these dollars if it revalues its currency – as it has lost on the dollars it has turned over to Blackrock in the hope of making more than the minimal 1% available on U.S. Treasury securities.

Describing China as "deliberately keeping its currency artificially weak. … feeding a huge trade surplus," Prof. Krugman adds that "in a depressed world economy, any country running an artificial trade surplus is depriving other nations of much-needed sales and jobs." In his reading the problem is not that America has let easy bank credit bid up housing prices for its workers and loaded down their budgets with debt service that, by itself, exceeds the wage levels of most Asian workers. This financialization is largely responsible for the U.S. trade balance moving into deficit (apart from food and arms exports). Homeowners typically pay up to 40% of their income for mortgage debt service and other carrying charges, 15% for other debt (credit card interest and fees, auto loans, student loans, etc.), 11% for FICA wage withholding for Social Security and Medicare, and about 10 to 15% in other taxes (income and excise taxes). To cap matters, the financial burden of debt-leveraged real estate and consumption is aggravated by forced saving pension set-asides turned over to money managers for financial investment in these debt-leveraged financial instruments, and "financialized" wage withholding for Social Security. All these deductions are made before any money is left to buy food, clothing or other basic goods and services.

Chinese currency appreciation would make its exports cost more. But would this spur America rebuild its factories and re-employ the workforce that has been downsized and outsourced? To imagine that long-term investment responds to immediately is Junk Economics Error #4.

The same is true of international commodity trade. "An undervalued currency always promotes trade surpluses," Prof. Krugman explains. **But this is only true if trade is "price-elastic," with other countries able to produce similar goods of their own at only marginally different prices**. This is less and less the case as the United States and Europe de-industrialize and as their capital investment shrinks as a result of their expanding financial overhead ends in a wave of negative equity. **To assume that higher exchange rates automatically reduce rather than increase a nation's trade surplus is Junk Economics Error #5**.[2] It is a tenet of the free market fundamentalism that Prof. Krugman usually criticizes, except where China is concerned.

Prof. Krugman urges the United States to do what it "normally does" when other countries subsidize their exports: impose a tariff to offset the supposed subsidy. Congress is increasing the drumbeat of accusations that China is violating international trade rules by protecting itself from financialization. "Democrats in Congress are threatening to … slap huge tariffs on Chinese goods to undermine the advantages Beijing has enjoyed from a currency, the renminbi, that experts say is artificially weakened by 20 to 25 percent." The aim is to make China "lift the strict controls on its currency, which keep Chinese exports competitive and more factory workers employed."[3] *But such legislation is illegal under world trade rules*. This has not stopped the United States in the past, but the believe that it might succeed internationally is Junk Economics Error #6.

This kind of propaganda does not see the United States as guilty of "managing the dollar" by its quantitative easing that depresses the exchange rate below what would be normal for any other economy suffering so gigantic and chronic s payments deficit. What makes this situation inherently unfair is that while the Washington Consensus directs other countries to impose austerity plans, raise their taxes on consumers and cut vital spending, the Bush-Obama administration blames China, not the U.S. financial system or post-Cold War military expansionism.

The cover story is that foreign exchange controls and purchase of U.S. securities keep the renminbi's exchange rate low, artificially spurring its exports. The reality is that these controls protect China from U.S. banks creating free "keyboard credit" to buy out its companies or load down its economy with loans to be paid off in renminbi whose value will rise against the deficit-prone dollar.

The House Ways and Means Committee is demanding that China raise its exchange rate by 20%. This would enable speculators to put down 1% equity – say, $1 million to borrow $99 million and buy Chinese renminbi forward. The revaluation being demanded would produce a 20,000% profit, turning the $100 million bet (and just $1 million "serious money") into making $2 billion. It also would bankrupt Chinese exporters who had signed dollarized contracts with U.S. retailers. So it's the arbitrage opportunity of the century that lobbyists are pressing for, not the welfare of workers.

The Internal Revenue Service treats such trading gains as "capital gains" and taxes them at only 15%, much less than the tax rate on earned income that wage-earners must pay. The Brazilian real has risen by about 25 per cent against the dollar since January 2009. Last week, Brazil's state oil company, Petrobras, issued $67 billion in shares to exploit the nation's new oil discoveries. Foreigners have been swamping Brazil's central bank with a reported $1 billion per day for the past two weeks – about 10 times its daily average in recent months – but this was largely to absorb money entering the country to take part in last week's issue by the national oil company.

The U.S. and foreign economies alike are suffering from the idea that the way to get rich is by debt leveraging, and that the wealth of nations is whatever banks will lend – the "capitalization rate" of the available surplus. The banker's dream is to lend against every source of revenue until it ends up being pledged to pay interest. Corporate raiders use business cash flow to pay bankers for the high-interest loans and junk bonds that provide them with takeover credit. Real estate investors use their rental income to service their mortgages, while consumers pay their disposable income as interest (and late fees) to the banks for credit cards, student loans and other debts.

But Paul Krugman and Robin Wells blame China for Wall Street's junk mortgage binge. Instead of pointing to criminal behavior by the banks, brokerage companies, bond rating agencies and deceptive underwriters, they take the financial sector off the hook: "Just as global imbalances – the savings glut created by surpluses in China and other countries – played an important part in creating the great real estate bubble, they have an important role in blocking recovery now that the bubble has burst."[4]

This sounds more like what one would hear from a Wall Street lobbyist than from a liberal Democrat. It is as if the real estate bubble didn't stem from financial fraud, junk mortgages, NINJA loans or the Federal Reserve flooding the U.S. economy with credit to inflate the real estate bubbles and sending electronic dollars abroad to glut the global economy. It's China's fault for running large trade surpluses "at the rest of the world's expense." The authors do not explain how it helps China or other economies to let foreign investors buy their companies at a 20% return and pay in dollars that must be recycled to the U.S. Treasury earning just 1%. And Congress won't let the Chinese buy U.S. companies. It blocks such inflows, managing the economy ostensibly on national security grounds – in practice a structural payments deficit.

Wall Street's idea of "equilibrium" is for foreign countries to financialize themselves along the lines that the United States is doing, then global equilibrium could be restored. But the most successful economies have kept their FIRE-sector costs of living and doing business within reasonable bounds, and are not remotely as debt-leveraged as the United States. German workers pay only about 20% of their income for housing – about half the rate of their U.S. counterparts. German practice is not to make 100% mortgage loans, but to require down payments in the range of 30% such as characterized the United States as recently as the 1980s.

The FIRE sector's business plan has priced U.S. labor out of world markets. There seems little likelihood of making Chinese and German workers pay rents or mortgage interest as high as the United States? How can American economic strategists force them to raise the price of their college and university tuition so that they must take on the enormous student loans of the magnitude that Americans have to take on? How can they be persuaded to follow the high-cost U.S. practice of adding FICA-type wage withholding to the cost of living to save up pensions, Social Security and medical insurance in advance, instead of the pay-as-you-go basis that Germany quite rightly follows?

Such suggestions are a cover story for America's own financial mismanagement. The U.S. idea for global equilibrium is to demand that that the rest of the world follow suit in adopting the short-term time frame typical of banks and hedge funds whose business plan is to make money purely from financial maneuvering, not long-term capital investment. Debt creation and the shift of economic planning to Wall Street and similar global financial centers is confused with "wealth creation," as if it were what Adam Smith was talking about.

A Modest Proposal

China is trying to help by voluntarily cutting back its rare earth exports. It has almost a monopoly, accounting for 97% of global trade in these 17 metallic elements. These exports are "price inelastic." There is little known replacement cost once existing deposits are depleted. Yet China charges only for the cost of digging these rare metals out of the ground and refining them. They are used in military and other high-technology applications, from guided missile steering systems and computer hard drives to hybrid electric automobile batteries. This has prompted China to recently cut back its exports to save its land from environmental pollution and, incidentally, to build up its own stockpile for future use.[5]

So I have a modest suggestion. If and when China starts re-exporting these metals, raise their price from a few dollars a pound to a few hundred dollars. According to theory put forth by Mr. Krugman and the U.S. Congress, this price increase should slow demand for Chinese exports. It also would help promote world peace and demilitarization, because these rare metals are key elements in missile guidance systems. China should build up its national security stockpile of these key minerals for the future – say, the next prospective five years of production. Let this be a test of the junk paradigms at work.

Notes

1 Paul Krugman, "China, Japan, America," *The New York Times*, September 12, 2010.

2 I discuss this well-known principle in *Trade, Development and Foreign Debt: A History of Theories of Polarization v. Convergence in the World Economy* (new ed. ISLET 2010, available on Amazon.com).

3 David E. Sanger, "With Warning, Obama Presses China on Currency," *The New York Times,* Sept. 24, 2010.

4 Paul Krugman and Robin Wells, "The Way Out of the Slump," *New York Review*, October 14, 2010, p. 16.

5 Nathan Hodge and James T. Areddy, "China Hold on Metals Worries Washington," *Wall Street Journal,* September 24, 2010, citing a House Committee on Science and Technology report and a *Joint Force Quarterly* article by Navy Reserve Lt. Cdr. Cindy Hurst.

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