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Geithner Is Exactly Wrong on China Trade

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Abstract (Summary)

The new consensus is that America failed to react to the building trade deficit with China and the global "savings glut," which fueled our housing boom. Propelled by local knowledge and a zero corporate tax rate, the TVEs by 2000 accounted for half of China's output.

Full Text (981 words)

Treasury Secretary-designate Tim Geithner's charge that China "manipulates" its currency proves only one thing. Three decades after Deng Xiaoping's capitalist rise, America's misunderstanding of China remains a key source of our own crisis and socialist tilt.

The new consensus is that America failed to react to the building trade deficit with China and the global "savings glut," which fueled our housing boom. A "passive" America allowed China to steal jobs from the U.S. while Americans binged with undervalued Chinese funny money.

This diagnosis is backwards. America did not underreact to the supposed Chinese threat. It overreacted. The problem wasn't "global imbalances" but a purposeful dollar imbalance. Our weak-dollar policy, intended to pump up U.S. manufacturing and close the trade gap, backfired. Currency chaos led to a $30 trillion global crash, an energy shock, bank and auto failures, and possibly a new big government era. For globalization and American innovation to survive, we must first understand the Chinese story and our own monetary mistakes.

We've heard the refrain: China's rapid growth was a mirage. China was stealing wealth by "manipulating" its currency. But in fact China's rise was based on dramatic decentralization and sound money.

After 500 years of inward looking stagnation, Deng opened 1979 with a bang. He freed 600 million peasants with history's largest tax cut. He emulated Hong Kong and Taiwan by establishing four Special Economic Zones on the sleepy southern coast. Before Beijing hard-liners knew it, mayors across China were demanding similar low-tax, local-control freedoms. By 1993, 8,000 of these of these entrepreneurial free trade zones had swept the nation. Two hundred fifty million people migrated to this "new China," where tax rates were low and regulations few. Capital poured in from China and the world.

Township and Village Enterprises (TVEs) were an unexpected but powerful innovation. Fiercely competitive and locally owned, these quasigovernment entities escaped Beijing taxation. Propelled by local knowledge and a zero corporate tax rate, the TVEs by 2000 accounted for half of China's output.

China needed an anchor for its complex transformation and in 1994 linked its currency, the yuan, to the U.S. dollar. The dollar-yuan link allowed a real price system to arise in China and created a single economic fabric stretching across the Pacific. Before long, the whole region had adopted what Stanford economist Ronald McKinnon calls the East Asian Dollar Standard.

The opposite of currency "manipulation," this dollar standard was a victory for free trade and global growth. But U.S. economists missed its portent. The Fed and Treasury of the late-1990s did not supply sufficient dollars to match rapidly growing global demand. A scarce dollar shot higher, and hard assets fell. Oil plummeted to $10 a barrel, gold fell to $250 from $400, credit shriveled, and dollar debtors across Asia went bankrupt. With an appreciating dollar and a world in turmoil, capital flooded into the U.S. and especially our soft, intellectual assets -- Cisco, Microsoft and dot-coms. The technology boom and bust was not a function of easy money but a scarce dollar.

In 2003, Alan Greenspan and Ben Bernanke identified an exotic threat: deflation. The Fed was seven years late. Mr. Greenspan's post-

9/11 liquidity had already ended the 1997-2001 deflation. Yet the Fed persisted with 1% interest rates through 2003-04 and easy money thereafter. Meanwhile, Treasury Secretary John Snow targeted China and its trade surplus as a big threat. He and his successor Hank Paulson agitated for a stronger yuan and thus a weaker dollar.

Treasury's trade-deficit mania encouraged anti-China politicians. Messrs. Snow, Greenspan, Paulson and Bernanke several times talked Sens. Chuck Schumer and Lindsay Graham off the protectionist precipice. But the administration did not realize that the weak-dollar policy was itself protectionism.

China was imparting deep changes on the world economy. Yet in 2003 U.S. manufacturing was 50% larger than in 1994. U.S. knowledge industries were generating most of the world's profits and wealth. American consumers were benefiting from low-cost imports. Meanwhile, many Asian goods were rerouted through China for final assembly. The U.S.-China trade deficit thus grew even as the total portion of U.S. imports from East Asia fell below 35% from 40% in 1990.

The real threat was a devalued dollar. In mid-2005, we finally forced China to delink from the dollar and mildly appreciate the yuan. Nevertheless, the trade deficit accelerated. Robert Mundell -- Nobel laureate, China expert, father of the euro and supply-side economics -- continued to warn that the trade deficit was perfectly natural. Worry about currency instability instead.

But other eminent economists urged a "more competitive dollar." On May 13, 2006, this newspaper headlined: "U.S. Goes Along With Dollar's Fall to Ease Trade Gap." All these "more competitive" dollars had to go somewhere, and with amazing efficiency found their way into oil and subprime mortgages.

The weak dollar had the opposite of its intended effect. Cheap-dollar commodities exploded the trade gap. Conceived to make the U.S. "more competitive," the policy channeled money away from technology innovators and into home-building and home-equity consumption. Inflation for a time does pump up demand, and so U.S. consumers bought, and Chinese growth shot even higher. Chinese, Russian and Middle Eastern foreign reserves grew, further depressing the yields of U.S. Treasurys.

Some credit indicators are now improving, but the Fed's past destabilization policy will reverberate. The weak-dollar blunder helped scuttle the Doha Round of trade talks and will make the successful Bush tax cuts difficult to preserve. American interventionism could absolve Europe's anti-innovation "antitrust" policy and excuse China's worst intellectual property violations and "national champion" subsidies.

And yet, with sound-money advocate Paul Volcker in the Obama White House and Mr. Mundell plugged into Beijing, the monetary mayhem of the last decade could give way to a worldwide, sound-money revival in 2009 and beyond.

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