



Conversely, if China suddenly stopped intervening in the foreign exchange market, it might trigger a sharp short-run decline in the international value of the US dollar and drive up US interest rates. That could cause a housing market collapse and a recession.

How did this problem arise? At the turn of the century, China's leaders finally achieved a reasonably well-balanced trade account. Rapidly rising exports were offset by imports that were growing equally fast. Economic growth was coming from housing, cars, infrastructure, and retail sales. Then an explosion of US imports and Chinese exports wrecked the balance.

Following the NASDAQ collapse in 2000, US consumption exploded due to relaxed monetary policy and a large swing in the federal budget from surplus to deficit. These policies kept the recession short and mild, but they also sucked in imports and created a massive US global trade deficit. China's exchange rate had very little to do with this. The US housing boom financed greatly increased consumption and removed the need for household savings, so American imports ballooned.

Second, Japan's huge trade surplus is increasingly credited to China. As Asian countries move final assembly of computers, shoes, and much else to China, the former surpluses of Japan, Taiwan, and Hong Kong increasingly show up as China's, while the good jobs and profits largely remain in those other places.

While China's share of the US trade deficit increased (from the previous peak of 27 percent in 1997 to 28 percent in 2006), the share of the rest of East Asia actually fell (from 43 percent in 1997 to 17 percent in 2006). America's trade problem with Asia has become proportionately smaller, but a superficial understanding of China's numbers makes it appear worse.

Third, China has experienced an explosion of credit, investment, and productivity. Banks had a lending frenzy that the Hu Jintao administration was slow to control. And China's privatization of urban housing and numerous state enterprises freed up large amounts of money for investment.

Simultaneously, the restructuring and privatization of China's inefficient state enterprises led to drastic improvements in manufacturing productivity and thus in China's competitiveness. There is no way that currency appreciation could have compensated for China's phenomenal productivity growth since 2001.

China's undervalued exchange rate is primarily China's problem. It creates too much domestic liquidity in China, which is driving potentially dangerous stock market speculation and other bubbles. The US Treasury Department is correct in trying to persuade China to marketize its currency faster on the basis of Chinese interest rather than foreign pressure.

While often well-intentioned, proposals to protect the US economy from foreign goods can backfire. A more protected US economy would be, like France's, an economy of far higher unemployment.

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