Blame The U.S. For The Housing Bubble, Not China

By David Boaz

In his New York Times Magazine column, Adam Davidson citedDavid Boaz of the Cato Institute as an economist who believes that easy money from China exacerbated the housing bubble in the U.S. In fact, Boaz places the blame much closer to home. His clarification is below.

Adam Davidson's citation of me as someone who believes "that all that easy money from China helped make the housing bubble much bigger and last longer, which created a far bigger crisis when the bubble finally burst" took me by surprise. It would be fine without that little prepositional phrase "from China." Easy money, yes. Housing bubble, yes. Pain when bubbles burst, absolutely. But is China to blame? I'd be inclined to point the finger closer to home.

This was a crisis caused by regulation, subsidization, and cheap money. Christopher Hitchens had a point when he wrote, "There are many causes of the subprime and derivative horror show that has destroyed our trust in the idea of credit, but one way of defining it would be to say that everybody was promised everything, and almost everybody fell for the populist bait."

There was substantial agreement in Washington for years that home ownership was a good thing and that more home ownership would be even better. Thus Congress and regulators encouraged Fannie, Freddie, and mortgage lenders to extend credit to under-qualified borrowers. To generate more mortgage lending to low and moderate income people, the federal government loosened down-payment standards, pressured lenders to increase their percentages of "affordable" loans, and implicitly guaranteed Fannie and Freddie's dramatic expansion.

All that hard work paid off: The share of mortgages classified as non-prime soared, and the quality of those loans declined. Fannie and Freddie's debt was implicitly backed by the U.S. Treasury –despite many warnings — and they were able to expand their debt and engage in risky transactions. As Lawrence

Summers wrote, "Little wonder with gains privatized and losses socialized that the enterprises have gambled their way into financial catastrophe."

Federal Reserve credit expansion, especially in 2001 – 2005, helped to make all this lending possible. "Everybody was promised everything" - cheap money, easy lending, and rising home prices. All that money and all those buyers pushed housing prices up sharply. But all good things - at least all good things based on unsustainable policies - must come to an end. When housing prices started to fall, many borrowers ran into trouble. Financial companies threatened to fall like dominos, and an ever-expanding series of bailouts began issuing from the Treasury department.

But what about China? China was eager to buy our debt, both Treasury bonds and Fannie and Freddie's debt. But it was Congress that ran the deficits, and the Fed that kept interest rates artificially low. We don't need to go to Beijing to find the villains in this piece.

So should we get tough on China? Adam Davidson has a point when he says that, "candidates always talk tough. Presidents opt for a gentle, nudging approach. They know that China, alone, gets to decide." I'd put it a little differently. Presidents usually realize that a trade war between the world's two largest economies is a very bad idea. China's currency is probably artificially low. But economists disagree on just how low. And if we don't know what it "ought" to be, how can we know what to do in response?

The real point of economic activity is not to create jobs but to add value, to create wealth and prosperity and a higher standard of living. Judged by that standard, we should probably be thanking China. If China is keeping its currency artificially low, it is hurting people who hold Chinese currency and subsidizing those of us who buy Chinese products. As the economist Mark J. Perry writes, "In the *best of all possible worlds* for the United States, China would use its labor and capital to manufacture consumer products like clothing, footwear, furniture, electronics, and appliances and send $300 billion worth of these products to U.S. consumers for free every year as a gift or a form of foreign aid to the American people. In addition, the Chinese would produce and send to America another $100 billion worth of raw materials, parts, industrial supplies, inputs, and natural resources at no charge, as a gift to American manufacturers every year."

They don't do that, of course. But if they're selling us products at a discount, American consumers are benefiting.

Our economy could use plenty of reforms – lower, flatter, simpler taxes; a more stable monetary policy or even a move toward free markets in money; reduced regulatory burdens; the de-monopolization of services from education to mail delivery; and less government spending. In all those cases, the problem and the solution are right here in the USA.