China's dollar trap

Paul Krugman

Back in the early stages of the financial crisis, wags joked that U.S. trade with China had turned out to be fair and balanced after all: They sold us poison toys and tainted seafood; we sold them fraudulent securities.

But these days, both sides of that deal are breaking down. On one side, the world's appetite for Chinese goods has fallen off sharply. China's exports have plunged in recent months and are now down 26 percent from a year ago. On the other side, the Chinese are evidently getting anxious about those securities.

But China still seems to have unrealistic expectations. And that's a problem for all of us.

The big news last week was a speech by Zhou Xiaochuan, the governor of China's central bank, calling for a new "super-sovereign reserve currency."

The paranoid wing of the Republican Party promptly warned of a dastardly plot to make America give up the dollar. But Mr. Zhou's speech was actually an admission of weakness. In effect, he was saying that China had driven itself into a dollar trap, and that it can neither get itself out nor change the policies that put it in that trap in the first place.

Some background: In the early years of this decade, China began running large trade surpluses and also began attracting substantial inflows of foreign capital. If China had had a floating exchange rate — like, say, Canada — this would have led to a rise in the value of its currency, which, in turn, would have slowed the growth of China's exports.

But China chose instead to keep the value of the yuan in terms of the dollar more or less fixed. To do this, it had to buy up dollars as they came flooding in. As the years went by, those trade surpluses just kept growing — and so did China's hoard of foreign assets.

Now the joke about fraudulent securities was actually unfair. Aside from a late, ill-considered plunge into equities (at the very top of the market), the Chinese mainly accumulated very safe assets, with U.S. Treasury bills — T-bills, for short — making up a large part of the total. But while T-bills are as safe from default as anything on the planet, they yield a very low rate of return.

Was there a deep strategy behind this vast accumulation of low-yielding assets? Probably not. China acquired its $2 trillion stash — turning the People's Republic into the T-bills Republic — the same way Britain acquired its empire: in a fit of absence of mind. And just the other day, it seems, China's leaders woke up and realized that they had a problem.

The low yield doesn't seem to bother them much, even now. But they are, apparently, worried about the fact that around 70 percent of those assets are dollar-denominated, so any future fall in the dollar would mean a big capital loss for China. Hence Mr. Zhou's proposal to move to a new reserve currency along the lines of the S.D.R.'s, or special drawing rights, in which the International Monetary Fund keeps its accounts.

But there's both less and more here than meets the eye. S.D.R.'s aren't real money. They're accounting units whose value is set by a basket of dollars, euros, Japanese yen and British pounds. And there's nothing to keep China from diversifying its reserves away from the dollar, indeed from holding a reserve basket matching the composition of the S.D.R.'s — nothing, that is, except for the fact that China now owns so many dollars that it can't sell them off without driving the dollar down and triggering the very capital loss its leaders fear.

So what Mr. Zhou's proposal actually amounts to is a plea that someone rescue China from the consequences of its own investment mistakes. That's not going to happen.

And the call for some magical solution to the problem of China's excess of dollars suggests something else: that China's leaders haven't come to grips with the fact that the rules of the game have changed in a fundamental way.

Two years ago, we lived in a world in which China could save much more than it invested and dispose of the excess savings in America. That world is gone.

Yet the day after his new-reserve-currency speech, Mr. Zhou gave another speech in which he seemed to assert that China's extremely high savings rate is immutable, a result of Confucianism, which values "anti-extravagance." Meanwhile, "it is not the right time" for the United States to save more. In other words, let's go on as we were.

That's also not going to happen.

The bottom line is that China hasn't yet faced up to the wrenching changes that will be needed to deal with this global crisis. The same could, of course, be said of the Japanese, the Europeans — and us.

And that failure to face up to new realities is the main reason that, despite some glimmers of good news — the G-20 summit accomplished more than I thought it would — this crisis probably still has years to run.

Greed and stupidity

David Brooks

What happened to the global economy? We seemed to be chugging along, enjoying moderate business cycles and unprecedented global growth. All of a sudden, all hell broke loose.

There are many theories about what happened, but two general narratives seem to be gaining prominence, which we will call the greed narrative and the stupidity narrative. The two overlap, but they lead to different ways of thinking about where we go from here.

The best single encapsulation of the greed narrative is an essay called "The Quiet Coup," by Simon Johnson in The Atlantic. Johnson begins with a trend. Between 1973 and 1985, the U.S. financial sector accounted for about 16 percent of domestic corporate profits. In the 1990's, it ranged from 21 percent to 30 percent. This decade, it soared to 41 percent.

In other words, Wall Street got huge. As it got huge, its prestige grew. Its compensation packages grew. Its political power grew as well. Wall Street and Washington merged as a flow of investment bankers went down to the White House and the Treasury Department.

The result was a string of legislation designed to further enhance the freedom and power of finance. Regulations separating commercial and investment banking were repealed. There were major increases in the amount of leverage allowed to investment banks.

The U.S. economy got finance-heavy and finance-mad, and finally collapsed. When it did, the elites did what all elites do. They took care of their own: "Money was used to recapitalize banks, buying shares in them on terms that were grossly favorable to the banks themselves," Johnson writes.

In short, he argues, the U.S. financial crisis is a bigger version of the crises that have afflicted emerging-market nations for decades. An oligarchy takes control of the nation. The oligarchs get carried away and build an empire on mountains of debt. The whole thing comes crashing down. Johnson's remedy is clear. Smash the oligarchy. Nationalize the banks. Sell them off in medium-size pieces. Revise antitrust laws so they can't get back together. Find ways to limit executive compensation. Permanently reduce the power of Wall Street.

The second and, to me, more persuasive theory revolves around ignorance and uncertainty. The primary problem is not the greed of a giant oligarchy. It's that overconfident bankers didn't know what they were doing. They thought they had these sophisticated tools to reduce risk. But when big events — like the rise of China — fundamentally altered the world economy, their tools were worse than useless.

Many writers have described elements of this intellectual hubris. Amar Bhidé has described the fallacy of diversification. Bankers thought that if they bundled slices of many assets into giant packages then they didn't have to perform due diligence on each one. In Wired magazine, Felix Salmon described the false lure of the Gaussian copula function, the formula that gave finance whizzes the illusion that they could accurately calculate risks. Benoit Mandelbrot and Nassim Taleb have explained why extreme events are much more likely to disrupt financial markets than most bankers understood.

To me, the most interesting factor is the way instant communications lead to unconscious conformity. You'd think that with thousands of ideas flowing at light speed around the world, you'd get a diversity of viewpoints and expectations that would balance one another out. Instead, global communications seem to have led people in the financial subculture to adopt homogenous views. They made the same bets at the same time.

Jerry Z. Muller wrote an indispensable version of the stupidity narrative in an essay called "Our Epistemological Depression" in The American magazine. What's new about this crisis, he writes, is the central role of "opacity and pseudo-objectivity." Banks got too big to manage. Instruments got too complex to understand. Too many people were good at math but ignorant of history.

The greed narrative leads to the conclusion that government should aggressively restructure the financial sector. The stupidity narrative is suspicious of that sort of radicalism. We'd just be trading the hubris of Wall Street for the hubris of Washington. The stupidity narrative suggests we should preserve the essential market structures, but make them more transparent, straightforward and comprehensible. Instead of rushing off to nationalize the banks, we should nurture and recapitalize what's left of functioning markets.

Both schools agree on one thing, however. Both believe that banks are too big. Both narratives suggest we should return to the day when banks were focused institutions — when savings banks, insurance companies, brokerages and investment banks lived separate lives.

We can agree on that reform. Still, one has to choose a guiding theory. To my mind, we didn't get into this crisis because inbred oligarchs grabbed power. We got into it because arrogant traders around the world were playing a high-stakes game they didn't understand.