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China's Dollar Trap

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Back in the early stages of the financial crisis, wags joked that our 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.