

## Ghost Money

Some people in Asia burn joss paper, also called ghost money, on the Lunar New Year, to give their deceased ancestors something to spend in the afterlife. Because ghost money doesn't represent a claim on any actual goods or services in *this* world, there is no reason for its issuers to exercise any particular restraint, and in Singapore it is possible to find notes issued by the First Bank of Hell, with the mythical Jade Emperor's picture on the front, in denominations ranging into the millions and billions of dollars. Perhaps we're counting on this charming tradition to make Asian investors comfortable with the prospect of continuing to add to their holdings of European and American sovereign debt, despite the obvious fact that the money they've already lent us is money they'll never get a chance to spend in this life.

We, in the West, all think seem to think that a sovereign debt crisis is a problem that can be deferred for a few years. We aren't going to default or inflate quite yet, not for a little while still, and we think our creditors should be as insouciantly untroubled about what might happen a little later on as we are. To anyone, like China's central bank, who is irrevocably committed to holding large amounts of our sovereign and quasi-sovereign debt to maturity, however, default or restructuring in 'a few years' is default or restructuring that will occur while he is still holding many of the same bonds he has now. It is money he has already lent us that will not end up being repaid.

We aren't even trying very hard to pretend that we intend to pay it. We're more or less at the point of no return now, yet a comprehensive reform of Medicare, Medicaid and Social Security, the only thing that could save the US from eventually defaulting on our obligations, is on absolutely nobody's political agenda, and by design won't be until after the crisis happens. The people who manage China's reserves aren't stupid. They do read the newspaper. If they know, *now*, that we are headed for effective default or restructuring in a few years, they should write the bonds down *now*. But if they are worth less, now, than they are trading for, why would they go on buying more of them? How could they? For them, the sovereign debt crisis is already happening. Every day, they have to decide whether to keep on throwing good money after bad, or lose everything right away.

The rational thing for an investor to do under these circumstances is to price sovereign debt on the basis of its actual risk of effective default. We can debate whether the yields of treasury bills are adequate compensation for the risks associated with holding them. If Europe and/or the United States are at all likely to have a sovereign debt crisis *at any point in the next decade*, though, the prices of ten year and thirty year bonds are still completely wrong. As there's absolutely no plausible story about how the growth needed to bring budget deficits down to prevent this is going to be generated – in fact the current plan in Europe is to repeat the mistake of 1931, and actually *raise* taxes in a depression, a path the US government also seems interested in following – the risk of such a crisis is objectively quite high, and the value of the bonds must be considered significantly impaired, whatever our utterly useless rating agencies say. A yield of three or four percent is just not adequate compensation for all this risk – not in Europe, not in the United States, and not in Japan, where yields are even lower. But if long-term government bonds were valued as if a sovereign debt crisis at some point in the next decade was as likely as many of us think it is, the European banks, at least, would be in very grave trouble.

The apparent plan, in both Europe and the US, has been to recapitalize the banking system through the 'carry' trade, by encouraging banks to borrow short (partly from government) and lend long (largely to government.) Thus, the banks were to be recapitalized by the difference between the rate at which the government lent and the rate at which government borrowed. The government,

however, was somehow supposed to not go broke in the process, though it certainly sounds like a bad deal to a naïve ear. (Of course, they *are* going broke...)

Analyzing the transaction a bit further, we can see that the money the governments lent *to* the banks, being fungible, was in fact the same money lent to the governments *by* the banks, so the banks were essentially lending themselves money via the government. This was supposed to recapitalize them, somehow, and to shift the risk of their bad assets to someone else. But who? Who ended up holding the risk? In America, the Fed actually purchased vast amounts of mortgage-backed securities, taking the risks associated with them out of private hands. Where did it go? To the guarantor of the Fed's balance sheet, the US government. And from there? Into the bond market, which funds the operations of the US government. And from there? Back to banks and private savers, where it started, where it always ends up, meaning that exactly nothing at all was accomplished by the whole expensive cycle.

The same sort of story could be told about every recent government intervention in markets. Risk has systematically been shifted from the banking system to the banking system. It is hard to believe that many banks will actually turn out to have been successfully recapitalized in this way, once the system equilibrates. Without any significant cuts in government spending or increases in taxes (in fact most governments are actually spending more, in the name of stimulus) the only new money available to the government comes from financial markets themselves, so using it to try to rescue financial markets on more than a short-term basis is probably futile.

Simply endlessly printing more money is more likely to lead to catastrophic failure – devaluation, inflation, default, or all three – than to any permanent rescue of the situation. That, in an open economy with large cross-border trade and capital flows, debasing your currency is not a long term solution to any real economic problem is something we've known for a rather long time. A one-off devaluation is sometimes useful, but the endless abuse of seigniorage has not traditionally been viewed in a very favorable light. Someone will pay in the end; now we are beginning to see who it is. Anyone who holds a lot of sovereign debt is at risk of eventually discovering that it is fairy gold, ghost money, mere joss paper that didn't ever correspond to any pile of goods and services actually available in this world. (Imagine an endless stream of ships leaving America full of cargo and returning from China empty, as if we were paying war reparations, individual Americans making terrible personal sacrifices to make sure the debt was paid.... The scenario is just so implausible.)

Macroeconomic policy in the developed world makes equally little sense. Ben Bernanke apparently only knows one trick, Keynesian stimulus with quantitative easing, which he advocates as the proper response to any situation – terrorism, a tech bubble, a banking crisis, a currency crisis, fiscal insolvency, Y2K, a Martian invasion, you name it. The problem is that, this time, we also apparently only ever seem to have considered one scenario, one possible world. The stimulus was supposed to work. The developed economies were supposed to bounce back strongly in a year or two. Apparently the probability weighting we attached to this particular scenario was one hundred and one percent.

Historically, many economists have been skeptical of the efficacy of Keynesian stimulus. Certainly, it's no magic bullet. If there is something fundamentally wrong with your economy, if there are unsustainable imbalances or supply-side shocks, Keynesian stimulus can't magically cancel all the pain you need to go through to correct the real-world problem. If you're already spending more than you have, Keynesian stimulus will only make things worse. If your problem is that new technology has made many workers' skills obsolete, Keynesian stimulus will not make the technological change

go away. The idea that Keynesian stimulus could have prevented the Great Depression is a science-fiction story about parallel worlds; there's no real-world evidence for it at all, we should take it just as seriously as any other plausible fiction. So it would have made sense to give some weight to the possibility that the stimulus might not work, the possibility that the depression would drag on.

In that possible world, the world that, as it now turns out, happens to be the actual one, borrowing as much as we have in the last two years to 'tide us over' will turn out to have been a very dangerous thing to do. Without a strong recovery in employment and tax receipts, large deficits will continue into the indefinite future, even though we're already rapidly approaching a level of debt that is unsustainable. Default, devaluation, inflation, or all three are becoming inevitable. And a world in which the United States is effectively bankrupt is going to be a chaotic one, as we cut the only significant military force left in the world back to levels that will make it impossible for us to play our current role of guardian of the world's security. We're all in; absolutely everything is now in play.

It was unbelievably reckless to bet the future of the whole world on the forlorn hope that state policy could overcome economic reality, but that's what we've all done, and the current Treasury Secretary seems desperate to have us continue. Presumably the decision was made on a business-as-usual basis, by consulting constituencies and considering appearances. Suicide, but sober, responsible, thoroughly canvassed suicide, with all the stakeholders having a finger on the trigger. The rapidly approaching catastrophe should finally allow Bernanke to definitively displace Victor Geraschenko, who presided over the agonizing collapse of the Soviet economy, as the worst central banker in history.

The main Western response to all this – to the fact that we've borrowed vast sums of money from the Chinese and other people, some of whom are much poorer than ourselves, and don't actually have a plan that would let us pay all of it back – seems to be to feel anger at China for having put us in the position of being able to default on them. Somehow, we all manage to construe this situation as them having nefariously acquired power over us while we weren't paying attention, even though in fact it's the creditor, not the debtor, who gets hurt most in a default. But that's idiotic, it's the sort of justification people used to give for persecuting Jews.

When you borrow a lot of money from someone, if you're a certain unpleasant sort of person, when they ask for it back, you find some excuse to not pay them, some reason why the whole situation is an unreasonable imposition on your patience, thereby absolving yourself from the guilt you ought to feel for having cheated someone who trusted you. Apparently that's what the West has become, a whining, self-righteous deadbeat who thinks everyone else ought to pay for his luxuries and throws a temper tantrum when he is asked to give back any of the money he's borrowed. We've all become Homer Simpson, and we don't know whether to resent or laugh at the pitiful schmucks who actually expect us to take responsibility for our own choices.

Should the Chinese people be angry about all this? Yes, probably, but not at the West. These things happen, and it's not the job of the American voter to take care of ordinary people in China. That's the responsibility of the Chinese government, so if citizens of China are annoyed at the situation, it's the incompetence, or speaking a little more accurately the heedless folly of their own government that should annoy them. The Communist Party lent the Americans the money, so it's the Communist Party who's to blame if the gamble has not paid off.

What were they thinking when they did it? Contemptible things.

Everyone in China can agree on the goal of restoring that nation to what Chinese people see as its rightful place in the world, a position of paramountcy, or at least equality, that will undo the humiliations of the last two centuries. The question is how to get there. What Mao tried would never have worked. If you want to master a skill which you currently lack and which someone else has, you watch what they're doing, and learn how to do it their way, first, before trying to make up some much better way of your own.

What the Chinese Communist Party is trying now is a little better, but not much. Having first tried the thirteen-year-old's method of completely ignoring everything everyone knows about how economic development is done and making up some imaginary way of doing it on the basis that it's emotionally satisfying, they've now moved on to the seventeen-year-old's method of taking a casual glance at what the other people are doing and supposing you've mastered it because you've seen a tiny part of it, without ever really bothering to find out how hard it actually is or whether the methods you've seen are appropriate ones for your situation. Actually, your reckless teenage way is *better*... until it kills you, that is.

Having failed definitively with Maoism, the CCP decided it ought to blindly imitate whatever it was that had worked for the other Asian economies. If export-led growth with the developed world as the primary market had worked for Singapore and Taiwan and South Korea, presumably it would work for China as well. The problem is that 'presumably'.

Export-led growth works well in a world where the price elasticity of demand for the exported goods is effectively infinite, where any decrease in costs will always lead to an expansion in sales. Even in a world like that, though, sooner or later the very development it brings about will put upward pressure on export prices. So even in a world where the first condition continues to hold indefinitely, sooner or later it will be necessary to switch to growth driven at least partly by domestic demand. But large countries like Japan and China are bound to run into another barrier as well. Eventually their exports will become so big relative to the economies they are exporting to that people in those countries will not be able to afford to continue increasing their purchases of the exports at the same rate year after year. A country the size of Singapore can afford to ignore the limits of their customers' purchasing power. But both Japan in the '80's and China in the last decade found themselves having to lend their export earnings back to the countries they were exporting to, to keep the growth in exports going.

Once you get to this point, it should be obvious to the exporter that he is never going to get paid back at today's prices. (Where would the money come from?) The importer is likely to try to avoid bankruptcy by forcing a revaluation on the exporter, which is politically easier for him than persuading his own voters to adopt the necessary austerity measures would be. The exporter, seeing this risk, will frantically try to switch over to an economy based on domestic demand. Whether or not he can do this depends on the condition of his political system.

If, in the course of the economic development that has already ensued, a rising middle class has already forced or is in the process of forcing meaningful democratic reform, there is some hope for a successful transition to a fully developed economy, because then there is the right setup for a consumer society with things like actual independent trade unions to force wages up in the face of resistance by employers, and a real social safety net that meets the needs of actual, powerful voters. Taiwan and Korea are examples of places that have started down this path, apparently successful transitions to genuine developed country status. Or if the exporting country is tiny, like Singapore, so that it can basically be run as a multinational corporation that happens to own some territory, it

may be able to go on functioning parasitically in the interstices of world civil society. But if the country is big, if one Party – call it the LDP, call it the Communist Party, call it what you like – continues to enjoy a monopoly of power, if the economy is still extensively planned, if the education system is still all about indoctrination rather than creativity, and in general if the exporting country continues to be the sort of place in which the nail that sticks out gets hammered down, then the attempt at a transition is likely to fail. In Japan we see a very mild version of what this can mean. Other failed attempts to reach true modernity have ended in much worse ways. The collapse of the Soviet Union comes to mind. When the revolution of rising expectations encounters an obstacle it can't get past, ugly things begin to happen, and many of the gains captured at an earlier stage in the process can easily be lost.

In China's case, it should have been obvious, at the beginning of this whole game, that the country's sheer size made imitating Singapore or South Korea a dubious proposition. A market that is effectively infinite from the point of view of a country that has a population of a few millions can't be expected, by a rational person, to have the exact same quality from the point of view of a country with more than a billion people. You're going to run into the limits of your customer's ability to pay at a much earlier stage in the process. This means that per capita GDP will be much lower when you have to try to make a transition to a consumer society. A low per capita GDP implies a smaller middle class as a fraction of the population. That means you are less likely to already have, or be constructing, anything like a real democracy.

In Japan there are cultural obstacles – basically, an expectation of loyalty unto death to everything from your political party to your yogurt drink brand – that make a real democracy with frequent, performance-based changes in which party is in power a difficult goal to attain. Japanese people *want* to endlessly endure pointless hardship; it's who they are, they don't have much else. When Japan finally met its crisis, when it was necessary to stop exporting and hammering down nails and start inventing and encouraging individualism, it balked at the fence, and has never really recovered.

China may have better cultural equipment for democracy – Chinese people certainly like to argue, and democracy is working, to some extent, in Taiwan. But, given the country's massive size and the low level of development at which the crisis would inevitably have to occur, it would have been wise of the Party to start developing the capacity for intensive economic growth and a consumer society as quickly and thoroughly as they could. Letting Zhao Ziyang conduct democratic reforms instead of massacring all those students at Tiananmen would have been a good start. India seems to be on a sustainable development path. China could have become more like India, or Taiwan, or South Korea. Instead, the Party has gone as far as it possibly could in the opposite direction, in the direction of denying Chinese people basic human rights like free speech and free assembly. Instead, it seemed better to them to lend the money Chinese people should have been spending on the pursuit of their own happiness to a bunch of deadbeats in the West who were never going to pay it back, just so they and their children and grandchildren could avoid the inconveniences associated with things like elections and strikes and writs of habeas corpus. The result of the Party's actions is that the country is woefully unready for the economic and societal transformation it must now make.

The Chinese government has trouble seeing all this. People in the Party think they understand the modern West, because they've visited the Louvre and met a few western people, but actually they don't, they don't know it at all, any more than most Westerners do. They don't seem to know very much of its actual history, for one thing. Their laws are supposed to prevent them from even inquiring into that, to force them to blindly believe whatever Marx and Mao believed. Consequently,

Chinese leaders have a one-sided, partial, idiosyncratic, obsolete, shallow understanding of the modern West. They are all physiocrats, but don't even know that there is such a word. They don't really seem to understand what modernity is, or what it requires, or how it is connected to freedom. That's a significant weakness, because it means that they haven't actually bothered to inquire very deeply at all into the thing that's most material to their country's ultimate fate.

If they had, they would know that the project of developing economically without acquiring any unwanted human rights in the process is an inherently self-contradictory one. In the history of the West, the rights came first, and much of the scientific and economic progress was a consequence of those rights. Places like Athens in the fourth and fifth centuries B.C.E., and the Netherlands in the sixteenth and seventeenth centuries have been the cradles of both political freedom and the developments in mathematics, science, law, philosophy, and other subjects that gave us the modern world. There is good reason to believe that this is not an accident. A properly realized modernity is necessarily free. No dictatorship, no single-party Leninist state, has ever made it all the way to a sustainable, competitive modernity without a democratic transition.

We Westerners tend to coddle and patronize people outside the West, telling them comfortable, multi-cultural, relativistic lies, humoring their Marxism or Ming restorationism or whatever crazy obsolete thing it is they are working with because we don't expect anything better from barbarians. Let me now violate this quaint custom by being perfectly clear with the Chinese people. You're no threat to us, in fact you deserve our pity. We both seem to be in trouble now, but the difference between us is that we will adapt and recover, and you will not. We will throw our current leaders out, eventually, and replace them with less incompetent ones, but you can't do that. Your leaders have failed you once again, yet you have no more ability to get replace them than you did with the Dowager Empress or Chairman Mao. You will never make it to the point of being a serious rival for America this way. You are trying to compete with a formidable opponent with one hand tied behind your back, merely because your leaders don't trust you to make your own decisions about where to strike.

This difference is not one between Chinese and Western culture, though that's what your masters want you to think - it is the difference between free people and serfs. (Chinese culture involves playing the gu qin and writing poetry with a brush; the single-party Leninist state has nothing at all to do with Chinese traditions, being a recent Western invention.) It is simply impossible to both ban the teaching of Plato and Locke and have a truly developed economy or a genuinely modern society. That can work for a little while, a decade or two, but not for the generations and centuries required to really catch up. People who pretend otherwise are not really your friends. The West got to where it is by being what it is, and many revolutions against the dead hand of tradition were required in the process. Ideas matter, so freedom matters. To believe in a third way between freedom and slavery is nothing but a form of cowardice, a failure to come to grips with what's really necessary. Freedom is frightening. So are you men, or mice? Do you really expect that a timid, trembling, obedient mouse will ever rule the world, will ever take real power away from the people who dared to tame the lightning, and travel to the Moon?

In fact, despite its façade of capitalism and modernity, the Party is still making Mao's mistake of acting first and thinking later. Lending a lot of money to people who will never pay you back is only a symptom of the underlying folly - you have to believe in *something* that isn't true to believe that such an insane project is going to work out in the way you want it to, and any fixed untrue belief will eventually injure you somehow. It's easy for the Party to maintain that sort of belief in the face of inconvenient evidence, because anyone who advances another point of view can be sent to a work-

camp. So modern China is a sort of suicide machine, a train to nowhere with no emergency brake. It is deliberately designed to prevent the passengers from being able to avoid a crash. Not only does the Party espouse false beliefs, it seeks to prevent Chinese people from forming their own, true beliefs in the light of all the available information. Now it turns out it has had them all working long days these last many years just to pile up credit with the Jade Emperor. And who's down there in Hell, spending it all, no doubt on dancing girls and lavish banquets, and laughing uproariously at your present difficulties? Perhaps the Great Helmsman himself, with Jiang Qing pouring out the wine....