The Testing Time

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DAVID BROOKS

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This test is rooted in a global shift in economic power. The rise of China, the vast wealth of the petro-powers and easy monetary policies created an ocean of excess savings that had no obvious place to go.

This money was entrusted to a few thousand traders who sloshed it around the world in search of the highest returns. These traders live in a high-tech version of Plato's cave. They do not see reality directly. Instead they see the shadow of reality as it dances around in numbers on their computer screens. They form perceptions about other people's perceptions of where the smart money is going next, so they're three or four psychological levels removed from normal economic activity.

These traders are driven to take big risks because the glory goes to the biggest stars. And because they are human, they assuage their ensuing uncertainty with self-deceptions. They develop an excessive faith in "value at risk" computer models, which seem to calculate their exposure in soothingly rigorous terms. They adopt accounting techniques that tell them they're on firm footing. They go in for complicated financial instruments that promise "riskless risk" by dispersing risk into a million small pieces and casting them into the ether.

The economists talk about "mispriced risk" and "illiquidity" in the system. But many economists are trained to downplay emotion, social psychology and moral norms, and so produce bloodless and incomplete descriptions of what's going on. The truth is, decision-making is an inherently emotional process, and the traders in charge of these trillions become bipolar as a result of their uncertainty.

When things are going well, they don't think they're just lucky and riding a wave. They're infused with a sense that they have it all figured out. When these traders are in their manic phase, they flood countries and economic sectors with capital. Without meaning to, they dissolve the moral fabric and spoil their own profit zones.

Easy money severs actions from their consequences. National leaders find they can run up huge deficits with no negative effects. Congressmen lean on Fannie Mae and Freddie Mac to acquire more and more risk. Highly regulated banks find they have money to lend far and wide, and everyone else finds credit is easy. Families decide they can afford homes and lifestyles beyond their means.

It all feels great until it doesn't. Then when things go bad, the social contagion sweeps the other way (the computer risk models never quite get this). One minute there's an ocean of credit, the next minute there's barely a drop. Once ebullient traders become paranoid, realizing how little they know about their trading partners. They refuse to acknowledge the true value of their portfolios. Everything stops.

At these moments, central bankers and Treasury officials leap in to try to make the traders feel better. Officials pretend they're coming up with policy responses, but much of what they do is political theater. In reality, they're trying to cajole, bluff and calm their audience of global money-sloshers.

This is more than a mortgage problem. We live in a world in which trillions of dollars can move instantly, but they are in the hands of human beings who are, by nature, limited in knowledge, and subject to self-deceptions and social contagions. By one count, financial crises are twice as prevalent now as they were 100 years ago.

In his astonishingly prescient book, "The World Is Curved: Hidden Dangers to the Global Economy," David M. Smick argues that we have inherited an impressive global economic system. It, with the U.S. as the hub, has produced unprecedented levels of global prosperity. But it has now spun wildly out of control. It can't be fixed with the shock and awe of a $700 billion rescue package, Smick says. The fundamental architecture needs to be reformed.

It will take, he suggests, a global leadership class that can answer essential questions: How much leverage should be allowed? Can we preserve the development model in which certain nations pile up giant reserves and park them in the U.S.?

Until these and other issues are addressed, the global markets will lack confidence in asset values. Bankers will cower, afraid to lend. America's role as the global hub will be threatened. Europeans will drift toward nationalization. Neomercantilists will fill the vacuum.

This is the test. This is the problem that will consume the next president. Meanwhile, the two candidates for that office are talking about Bill Ayers and Charles Keating.
David Brooks's column has appeared on the Op-Ed page of The New York Times since September 2003. He is also currently a commentator on "The Newshour with Jim Lehrer."