

THE
UNFAIR
TRADE

HOW OUR BROKEN GLOBAL FINANCIAL
SYSTEM DESTROYS THE MIDDLE CLASS

MICHAEL J. CASEY



ALSO BY MICHAEL J. CASEY

Che's Afterlife: The Legacy of an Image

The Unfair Trade

*How Our Broken Global Financial
System Destroys the Middle Class*

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Acknowledgments

Notes

The View from James Street

I have a neighbor across the street in Pelham, New York, whose good humor, intelligence, and well-stocked collection of single-malt scotch make him an ideal companion with whom to mull over the world's problems. An avid and thoughtful reader, Scott would repeatedly tell me that he hoped my book would give him reassurance. He wanted to be convinced that, after the financial turmoil and political uncertainty that have characterized America's recent experience with globalization, eventually "everything is going to be all right."

Given the spectacular recent failures of the financial system I was writing about, Scott's request for optimism was a tough ask. Still, I did respond by laying out what I saw as some of the hopeful signs of progress that globalization has delivered. There was the fact, for example, that between 1990 and 2005 the number of people living on less than \$1.25 a day dropped by 400 million, putting the world on track to far surpass the UN's Millennium Development Goal of halving the rate of extreme poverty between 1990 and 2015. Or there was the seven-year increase in life expectancy from 1990 to 2010, the 47 percent decline in infant mortality over the same period, or the 11-point rise in literacy rates to 84 percent for people age fifteen and over. The relentless advance of a 1.3-billion-strong China over that time disproportionately pushed up the aggregate results, but this newfound upward mobility is truly a global phenomenon. It has spread across Asia, Latin America, and Eastern Europe. Even sub-Saharan Africa, the forgotten continent, is posting gains, with growth rates averaging 4 percent over the past four years and social indicators in health, education, and general development all showing real improvements since 2000. On an international level, Adam Smith has been largely proven right: free trade and integration led to greater and more efficient production of goods and services for all.

Yet it's hard for Scott and hundreds of millions of Westerners like him to fully appreciate these advances. They associate globalization with disruptions to their lives and great instability—and for good reason. In 2008, the world was thrust into a nauseating financial crisis, the likes of which had not been seen in eighty years. And just three years later, with a new crisis rocking Europe, it was facing another bout of financial turmoil, this one potentially even more destructive than the previous one. These crises have shown that many of the jobs created before them were transitory, especially in the bubble-economics sectors of financial services, real estate, and residential construction. In the United States, where inflation-adjusted data show household income dropping 7.1 percent from 1999 to 2010 and the median wage of male workers unchanged from 1968, inequality widened to levels not seen since 1928, the year that preceded the Great Depression. The top 1 percent of earners received 21 percent of the nation's total income in 2008, up from 9 percent in 1976, after having accounted for a whopping four-fifths of all income gains between 1980 and 2000. Globalization and the Internet have allowed U.S. labor productivity to increase on average

about 3 percent per year since 1995, but the income gains from that improved efficiency have flowed almost entirely to the upper echelons of American wealth. Although everyone's life has been enriched to some extent by a greater abundance of affordable goods and by exponential developments in communications and medical technology, the majority has slipped enormously in relative terms. Yet even that disparity could be rationalized into some concept of an improved overall quality of life if it weren't for a new element that these crises have introduced: a profound sense of uncertainty about the future.

I traveled widely to research this book, and from one continent to another I encountered people who'd lost their faith in political and financial institutions. I heard it from bankrupt homeowners in different parts of the United States, from underinsured laborers in southern China, from terrorized factory workers in Ciudad Juárez, Mexico, from rent-choked retailers in Hong Kong, from duped savers on the Channel Island of Guernsey, and from the unemployed of the Costa del Sol and Reykjavik. And it's not just among these hardest-hit cases. For the first time, an April 2011 Gallup survey showed that a majority of Americans—society dominated by the middle class, to which Scott belongs—believed it was “very or somewhat unlikely” that their children would enjoy a standard of living better than their own. Worldwide, this emotional reaction has manifested both in a backlash against the political establishment and in deep divisions within that establishment. It is reflected in the political advances of nationalist anti-euro movements in Finland and other parts of Europe, while the governments of the United Kingdom, Germany, Ireland, Greece, Portugal, the Netherlands, and Belgium all struggled to sustain parliamentary majorities. It is also apparent in the rise of both the U.S. Tea Party and the Occupy Wall Street movement, as well as in the uncompromising Washington partisanship that let the credit rating of the world's biggest economy fall victim to what looked to the rest of the world like a schoolyard brawl. The divisions that threatened to turn the 2012 U.S. presidential election into a bitter class battle stem from this discontent.

Yet the root cause of all this angst is neither global integration nor an insensitive free market. Rather, it's founded in an internationally inequitable and unbalanced mix of policies that have created perverse economic incentives and so have undermined the functioning of global market forces. This network of flawed policies distributes the spoils of integration unfairly, benefiting politically privileged elites and holding back everyone else. This is ultimately what has filled people's lives with uncertainty and instability. And given that these disruptions are directly correlated with the broad advance of globalization, it is hardly surprising that many want the process of integration reversed.

My neighbor Scott has an appreciation of how the lives of many around the world have changed for the better, but as he puts it, “I can't think about that. I have to think about what globalization means to me, and I simply can't conclude that it is positive. If my job is outsourced, what can I do? I'm a midcareer manager with a wife and a nine-year-old daughter to support. There's no way to retrain me into something more competitive, more globally adept. I have to ask myself, 'How do things look from here, from James Street?' And they're not better. They're worse.”

Who can dispute that viewpoint? Here's a decent, hardworking man who seeks the security of the status quo, not a bigger piece of the pie. He's not greedy. His greatest desire is to ensure that his child has the same opportunities he had. And how is that any different from

me? My wife and I chose to live in Pelham because its schools offered the best we could afford for our daughters. So much for integrating with the world; Pelham isn't even integrated with neighboring Mt. Vernon and the Bronx, where incomes are lower, the schools have fewer resources, the crime levels are higher, and the life prospects for children are poorer. This is our deliberate choice. I can make all the high-minded analyses I like about the benefits of globalization, but my priorities are also based on what's best for my immediate family, on what happens at the local level. Don't we all view the world from our own versions of James Street?

Here lies the crux of the challenge ahead. Globalization is an unstoppable train. Even if we wanted to return to a world of protectionism and high tariffs, or if a political backlash led to the dissolution of the World Trade Organization (WTO), the modern intricacies of global supply chains make such a return nearly impossible. And yet the instinct to resist the disruptive changes that come with greater integration is strong. We all feel it to some extent, and so unwittingly act as agents of the distorting policies that protect the dysfunctional status quo. It has always been so. Throughout modern history, technological change and the accompanying expansion in human capability have run up against an instinctive conservatism, leaving our social, political, and legal structures ill-prepared for these new realities. (Think of how ethical boundaries have persistently been challenged by scientific and medical advances over time—from Galileo to stem cell technology.) This, at its core, is what Europeans were grappling with as their debt crisis came to a crunch moment in late 2011. Their financial markets had computerized and globalized so rapidly that they now operated in an *international* sphere where time and distance were no longer a barrier to commerce. But their politics—and therefore the financial regulatory apparatus deployed to manage those markets—were anchored in older institutions that intrinsically protected *national* interests. This mismatch, a product of the same, innate resistance to sweeping change that Scott and I both experience, left Europeans inadequately prepared for the financial maelstrom into which they were hurled. Americans and other non-Europeans are by no means immune from such breakdowns either. As we will see in the pages ahead, tensions between forward-marching globalization and stagnating national politics are on the rise everywhere. My goal is to demonstrate how, in hanging on to a nonintegrated political status quo, we have failed to stop a powerful, globalized financial system from working against our common interest. In doing so, I hope to encourage readers to overcome this conservative instinct and push for reforms that steer globalization into the direction of a truly level playing field.

Even so, Scott's viewpoint demands attention: any serious attempt at reining in the power of global finance must first recognize the deep-seated human resistance to the changes that would entail. Such fear of the new is not something to be belittled or caricatured as backwardness. It is founded on nothing less than the dreams we hold for our children. We must give people reasons to hold on to such hopes. And yet it's fair to say that these wishes will never be realized if we don't reform our broken global financial system.

In our quest to understand this dysfunctional system, we'll first take a visit to the Bund in Shanghai's elegantly restored colonial district, and gaze across the Huangpu River at the spectacular Pudong skyline on the other side. When I look at it—and quite likely if Scott were to do so—thoughts of Manhattan immediately spring to mind. It's not that Shanghai

business district looks especially like New York's. In fact, with the skyward-reaching spire of the Oriental Pearl Tower drawing the eye, the scene is reminiscent of Toronto, with its dominating CN Tower. But I can't help but compare it to lower Manhattan's skyscrapers. Why? Because both skylines are culturally entrenched symbols of what the future might hold for both for these two giant cities' inhabitants and for the countries to which they belong.

More than the White House or U.S. battleships, the preeminent icon of American power in the twentieth century was Manhattan's skyline. Then a group that detested that power sought to destroy the image itself. In the decade following the World Trade Center attacks, the efforts meant that a view of the cityscape could conjure painful feelings of loss, not progress. Compared to the speed with which Shanghai was relentlessly reaching for the sky, the long delays in the construction of 1 World Trade Center, aka the Freedom Tower, seemed to symbolize a decline in American power. (That a China-based manufacturer was awarded the contract to make the impact-proof glass enveloping the tower only seemed to rub salt in that wound.) On that same island eight decades earlier, and in the midst of an even bigger economic crisis, teams of immigrant construction workers took just one year to build the Empire State Building from U.S.-produced materials. That aptly named accomplishment staked America's claim on the twentieth century. More recently, however, the hole that the fallen Twin Towers left in the Manhattan skyline hinted that this claim wouldn't be renewed for the twenty-first century.

By contrast, Shanghai seems desperate for the world to know that China now possesses the all-conquering spirit that turns a nation into an empire. Especially at night, when some buildings run giant video displays down their facades while brightly lit barges float around like Christmas trees on the water, the Pudong skyline could have been lifted right out of the future. One can picture flying cars buzzing around the tops of its skyscrapers as if in a scene from *The Jetsons* or, more ominously, from the movie *Blade Runner*. Pudong was mainly farmland in 1990, when Deng Xiaoping flagged it as the site for a financial center that would lead his country into modernity. Now it represents the beating heart of Shanghai's rapid expansion, its ubiquitous construction cranes forming the vanguard of China's full-stear-ahead charge toward urbanization. No wonder Scott and millions like him fear that China is overwhelming us.

But like any symbolic reading, this assessment of the two cities misses the nuances of reality. With a bit more information, one can compose an equally compelling story that puts the two skylines in a symbiotic relationship. The industries that drive Shanghai and New York are interlinked via the trade and financial flows that arise within the China-U.S. economic partnership. The Shanghai of the twenty-first century was built upon the wealth generated by China's exporting colossus, which depends on consumers in the U.S. market. Because of China's exchange rate and monetary policies, as well as other rules that limit how much wealth trickles down to its 1.3 billion citizens, the export machine creates an ever-growing pool of dollar-based savings. A large part of those savings is commandeered by the People's Bank of China, which then transfers it to the U.S. government in return for its bonds. In an indirect but very significant way, that money helps sustain the securities trading businesses that keep New York's lights on. It's not for nothing that the city's real estate prices held up while homes across the rest of the United States plunged in value after the 2008 crisis. Nor should it be surprising that after \$24 billion had been spent on reconstruction, the area

around the World Trade Center was booming once the ten-year anniversary of the September 11 attacks came around.

Seen this way, Pudong and lower Manhattan are not adversaries but rather two halves of a powerful coalition. They are interdependent hubs in a Chinese-U.S. relationship that functions much like a single, fused economy—"Chimerica," financial historian Niall Ferguson calls it. But for all the wealth it generates, this is an inefficient international relationship, one that discriminates against different sectors of both countries' societies. Members of the prosperous business class in the bustling port cities along China's eastern coast—Shanghai, Shenzhen, Guangzhou, and Tianjin—are that country's biggest winners in this arrangement. Its losers are the poor and the lower middle classes from China's rural interior. Similarly, those most privileged by it in the United States are concentrated on or close to the two coasts: bankers in Manhattan, hedge fund managers in Greenwich, Connecticut, mutual fund managers in Boston, bond management firms in Los Angeles and San Francisco. America's losers, though, can be found throughout the fifty states.

This coast-versus-hinterland dichotomy in both China and the United States is exhibit A in our case for showing how the wide gaps in opportunities for people in different circumstances around the world reflect a fundamental failing in the structure of the global economy. As we'll learn, it all comes down to how policies set in Washington, Beijing, and other political capitals combine to create a dysfunctional global financial system that provides the biggest benefits to a privileged few while it subjects everyone else to uncertainty and instability.

Terry Gou has done extraordinarily well from this arrangement, not to mention from the weak exchange rate policy and the general pro-export orientation of China's economic model. Gou grew up poor in Taipei, but with a \$7,500 starter loan from his mother in 1974 he rode the China boom to personal wealth of \$5.7 billion in 2011, according to *Forbes*. Now the highest-profile member of a new breed of cross-Taiwan Strait businessmen, his company, Hon Hai Industries, better known by its trade name Foxconn, produces more of the world's consumer electronic products than any other. It has factories in ten locations in China and additional plants in six other developing countries, employing a total staff of almost 1.2 million. That's more people than are on the payrolls of Apple, Dell, Microsoft, Hewlett-Packard, Intel, and Sony put together. Indeed, Foxconn work teams churn out products for many of those marquee names. The reclusive Gou keeps his official residence in Taipei but he spends much of his time at Foxconn's Longhua manufacturing compound in Shenzhen, where workers assemble hot-selling items such as Apple's iPad and Nintendo's Wii consoles. He is notorious workaholic and a penny-pincher, although he does find the time and money to do other things, including shopping for \$30 million castles in the Czech Republic and pursuing his passion for tango dancing.

In 2010, Hon Hai Industries generated a staggering \$95.19 billion in revenues, the vast bulk of it earned overseas. That's about \$260 million a day, Terry Gou's own contribution to the money flows that prop up a dysfunctional world financial system. Until laws requiring exporters to repatriate their foreign earnings were relaxed in late 2010, these earnings are those of many other Chinese exporters would automatically return to China, along with billions more every day from thousands of other exporters, dollars that the fixed exchange rate policy of the People's Bank of China (PBOC) compelled it to acquire. Even after those

changes, exporters such as Hon Hai continued to bring their earnings back into China, most because they knew the exchange rate was undervalued and destined to keep rising. At the time of writing, the yuan had risen by about 7.3 percent against the dollar in the eighteen months that had passed since the central bank ended a two-year policy of rigidly fixing the exchange rate and began making tiny daily upward adjustments to it. Then, at the end of 2011, with the global economy entering another slowdown, yuan inflows eased and sometimes even turned to outflows as investors speculated that the government would abandon the appreciation policy, just as it had during the recent global economic crisis. But although there were varying opinions about the yuan's fair value, analysts generally agreed that the Chinese currency was still considerably undervalued against virtually all of its trading partners' currencies. The fact that the PBOC added about \$1 trillion in reserves during the period of appreciation was proof of undervaluation and therefore of a mercantilist policy that's deliberately intended to support Chinese exporters.

Intervention on such a scale has sweeping global implications. C. Fred Bergsten, the director of the Peterson Institute for International Economics, called it the "largest protectionist measure adopted by any country since the Second World War—and probably all of history." There will come a time when the yuan is no longer considered undervalued and a European or U.S. recession that hurts Chinese exports could hasten that moment. But the global distortions created by the interventions of the past decade will take many, many years to undo.

Fueling these distortions is a giant, endless circle of dollars that flows between China and the United States. It starts with the earnings that Chinese exporters such as Foxconn make when they sell their products to Americans. Those proceeds find their way to the People's Bank of China, which then sends them back to the United States, where they help create the credit with which Americans buy more Chinese goods and stoke the incomes of New York bankers.

Even though its power has waned slightly, the gargantuan Chinese export sector's revenues produced an average trade surplus of around \$13 billion a month in 2011, or just under \$750 million per business day. Those foreign earnings, along with inflows from approved foreign investors in land, plant, and machinery, as well as from any foreigner who can get around the government's strict capital controls to speculate on Chinese financial instruments, meant that many more dollars came into China than yuan were sent out. Only purchases by the PBOC, which relentlessly sold yuan in return for dollars, would prevent this perpetual inflow from pushing up the local currency's value beyond its tightly managed exchange rate target. To pay for those purchases without pumping new inflation-stoking yuan into the economy, the central bank issued yuan-denominated bonds to Chinese banks, which were flush with cash deposits drawn from China's enormous store of household and corporate savings. After effectively converting these savings into foreign currency, the PBOC then had to decide where to invest it overseas. By mid-2011, accumulated reserves hit \$3.2 trillion as of September 30, 2011. There simply aren't enough foreign markets big or liquid enough to ensure that prices don't tip against such a central bank when it buys or sells, and that are legally stable enough to protect future transactions. Thus the PBOC typically, albeit reluctantly, steered most of its money into U.S. Treasuries, the bonds of the world's major reserve currency. Chinese foreign reserves fell slightly in the latter part of the year to end

at \$3.18 trillion. This was partly explained by the burst of speculative outflows that occurred in December, but there were also hints before then that Chinese banks were being told to hold onto dollars rather than sell them to the PBOC. If it accepted those dollars, the Chinese central bank would have had to gorge itself even more on Treasuries, and by then it would have been suffering indigestion.

Central banks from other trade surplus countries, including the Bank of Japan, have had to make similar choices, but none has ever bought Treasury bonds as voraciously as China, which has in one decade trebled its reserves to far outrank any other country. As of September 2011, China officially owned \$1.15 trillion of the U.S. government's \$14.3 trillion Treasury debt. It also maintained massive holdings of debt issued by the now government-owned home loan agencies Fannie Mae and Freddie Mac. The true figures are likely to be far higher than these Treasury data suggest. Beijing's reserve managers are believed to disguise their purchases of U.S. securities—presumably so as not to show their hand and have the market work against their interests—by channeling their transactions through private banks in the U.K. and U.K.-based money managers. Suspiciously, the September 2011 Treasury data show Chinese holdings of Treasuries virtually unchanged from a year earlier, while those registered to U.K. residents more than doubled with a gain of \$231 billion, exceeding that of any other country—even Japan, the other great reserves-owning behemoth.

While there are many other sources of demand for U.S. Treasuries, the marginal effect of China's purchases is so large that it can't help but support U.S. bond prices. That in turn keeps down the yield that investors earn on those securities. (By definition, yields move in inverse relation to prices on bonds and other fixed-income securities.) Over time, this has allowed the United States to roll over its enormous calendar of expiring debt at dirt-cheap borrowing rates—which hit a record low of 1.67 percent for ten-year bonds in September 2011. In effect, China is an enabler of America's debt accumulation and its steep fiscal deficit, which the Congressional Budget Office projected to reach 8.5 percent of gross domestic product (GDP) in 2011. The cross-Pacific savings flows—and, more broadly, the privilege of controlling the world's reserve currency—encourage political short-termism in the United States, which means that reforms urgently needed to bring down the country's long-term deficits are postponed. It was disturbing how little attention was focused on this international aspect of America's debt problem during the rancorous debt ceiling debate that resulted in the ignominious downgrading of America's credit rating by Standard & Poor's. A debate that was reduced to overly simplistic mantras—"taxes kill growth" from the right, "Social Security can't be touched" from the left—ignored the elephant in the room. America's debt challenges are inseparable from the problem of global imbalances.

The last thing a big investor like China needs is a future debt crisis in the market in which its holdings are concentrated. Yet by entering into what can only be described as a codependent relationship, Beijing is helping to foster the kind of U.S. fiscal problems it most fears. China cannot be blamed for an irresponsible budget process, but the fact is that the perpetual demand for U.S. government bonds created by its excess savings and managed exchange rate policy makes it easier for Washington to put off the hard decisions. Without China paying a high price for the United States' debt, Congress would have been forced into reckoning over deficit reduction many years earlier. Just as high market interest rates on government debt will force politicians' hands on tough decisions—as with Greece, Ireland,

Portugal, and Spain's adoption of tough austerity measures during the recent euro zone sovereign debt crisis—low rates tend to breed complacency. What's more, they encourage willingness to take on debt across all of society. Since Treasuries are the benchmark for pricing every other form of credit, their rising prices and falling yields ripple through America's financial markets, pushing investors to seek better deals on higher-yielding debt securities. That brings down interest rates on other loans and creates temptations for borrowers. It also fires up the kinds of factories in which New York specializes: bond trading desks.

As the China-to-U.S. trade and finance cycle accelerated through the first eight years of the decade, the monumental international fund flow became the gasoline with which Wall Street's traders, salesmen, and financial engineers cranked up a prodigious new moneymaking machine. It was a marriage made in hell, as Chinese money, the fastest-growing source of U.S. finance, was taken in by America's underregulated, misincentivized financial sector and multiplied many times over into an explosion of excess credit. The profitable relationship meant that investment banks could promise the sky in salaries and so lure many of the sharpest young minds from around the world. Math graduates who might otherwise have discovered clean energy solutions at engineering firms ended up designing complicated new "securitized" and derivative products for banks to sell. Their inventions included the now notorious collateralized debt obligations (CDOs), into which were bundled thousands of home loans before they were chopped up into securities of differently ordered claims. In what seemed like financial alchemy, high-grade AAA-rated securities could thus be magically created from otherwise low-grade mortgages—all with a little help from ratings agencies, the able assistants of the Wall Street illusionists. It wasn't until 2008 that investors were reminded that there is no such thing as magic.

With demand from China's and other countries' central banks driving up the price of AAA-rated Treasury bonds—and thus pushing down their yields, or returns on investment—pension funds and other institutions whose charters required them to hold high-rated debt eagerly turned to these newfangled securities as substitutes. In the process, they delivered a river of fees to the Wall Street banks that designed them and to the ratings agencies that gave them their AAA stamp. As the CDO factory cranked up, it absorbed more and more mortgages into the securitization process, which freed up capital at the originating banks, allowing them to go out into suburban neighborhoods and recruit still more home loan clients. Most people saw it as a perfect, virtuous cycle that was fast-tracking the country to universal home ownership. Only as time went on did a few Wall Street insiders, their clients, and some savvy academics recognize that the system was a ticking time bomb.

Among the fortunes created by the young "quants" who fashioned these new instruments were those that accrued to Fabrice Tourre, to his employer Goldman Sachs, and to the firm's well-heeled clients. Tourre, a smart young graduate of the elite *École Centrale Paris* engineering school, joined Goldman at age twenty-two in 2001. He mastered the art of designing CDOs, as well some even more complex swap derivatives, and he was soon bestowed with the common Wall Street title of vice president. By the end of the decade, however, when an email to his girlfriend surfaced during a Securities and Exchange Commission (SEC) investigation, he'd become publicly known by a more notorious title.

“Fabulous Fab.” Written just before the financial crisis took root, his email read, “The whole building is about to collapse anytime now.... Only potential survivor, the fabulous Fab ... standing in the middle of all these complex, highly leveraged exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!”

The SEC used that message and a host of other data to file fraud charges against Tourre's employer. In a case that Goldman settled out of court for a record \$550 million, the SEC charged that in 2007, right at the top of the housing boom, Tourre knowingly assembled complex “synthetic” CDOs whose derivative-based structure was founded on dubious mortgages, and then passed them off to naive investors as if they were low-risk securities. Meanwhile, the SEC said, a better-informed and more privileged client used the same investment vehicle, which Goldman had named Abacus, to place short-selling bets against the securities. Months later, that client, hedge fund manager John Paulson, made \$1 billion for his Manhattan-based firm Paulson & Co. when waves of defaults started hitting the subprime mortgages inside the Abacus structure. It was a crowning moment in a year-long spree of bets against the housing bubble that earned Paulson & Co. a staggering \$15 billion. Paulson himself took home \$4 billion that year, catapulting him to sixth place on *Forbes* magazine's list of America's richest people. For his part, the then-twenty-eight-year-old Tourre earned a \$2 million bonus. After paying a mere \$4,000 a month in rent for his Greenwich Village apartment, Tourre could devote his winnings to other pursuits, including what his neighbors described as wild, all-night parties. Once the crisis hit, Tourre moved to Goldman's London unit. But after the SEC investigation broke in the spring of 2010, he was put on administrative leave. He continued to receive his salary and benefits while Goldman paid his legal fees in a case that was to leave the Frenchman, remarkably, as the only individual from all of Wall Street to be sued by the SEC on charges arising from the mortgage crisis.

While the elite businessmen and bankers who thrive off the U.S.-China relationship invariably reside in the big trade and financial centers on either country's coasts, the laborers and consumers who support the transnational enterprise often come from places farther inland. The way this deal has played out, it has left the skyscraping city as the victor and the hinterland as the loser.

Economic advancement does not come free. And in China, the heaviest price has been disproportionately paid by inhabitants of the rural interior and their single-child offspring. 220 million of whom have left home in recent years to work grueling shifts in coastal factories. These people, known as the “floating population” because they fall outside China's strict provincial system of residency, have their eyes on a brighter future. And eventually that may come to their children or grandchildren. But it need not be such a long, arduous path to prosperity. These people are better-off than they were in their villages, but that's not saying much. And throughout the boom of the past two decades, various discriminatory policies ensured that China's working-class majority has subsidized the well-connected minority that controls its export business. Due to a fixed, undervalued exchange rate, a set of rules that explicitly limit migrant laborers' access to education, health services, and social security, and a closed banking system, workers saw their purchasing power restrained and their investment options limited. Bereft of state support for retirement or health needs, these people and their relatives they leave behind are forced to save excessively, keeping their money on deposit

state-owned banks that pay very low government-mandated interest rates. This way, they contribute to a growing pool of funds that's used to finance the export machine. They deliberately repressed interest rates. As Peking University professor Michael Pettis described it, China's growth is built upon "the rape of household savers."

Industrious workers like twenty-one-year-old Xui Li (not her real name) sacrifice life, love, and family to save for the future while their employers become rich on their labor and their underremunerated savings. Born in a small village in Hubei province, Xui Li moved to Shenzhen in 2010, where, when I met her, she was working and living in the Longhua headquarters of Terry Gou's Foxconn plant—together with 300,000 others. Occupying almost an entire square mile, the sprawling, enclosed compound is a city unto itself. Inside, lines that would distinguish Xui Li's private life from her work life were blurred. Most of her waking hours were spent before a stream of semi-assembled Hewlett-Packard printers, into which she snapped the internal belts that drive their cartridges. Putting in ten-hour shifts, she said her team assembled 2,400 separate units each day. She worked six days a week and earned 1,200 yuan, or about \$200, a month. That amount was less than the standard Foxconn wage, but was due to increase after she'd completed six months at the factory. Xui Li left the compound only once a week—on Sunday, her day off, which is when I encountered her among hundreds of young men and women streaming out of the entrance of the Foxconn headquarters in Shenzhen. She slept in a bunk bed in a female-only dormitory, ate virtually every meal in one of many cavernous cafeterias in the compound, and even spent her social time attending Foxconn-sponsored events. She wore the same uniform as everyone else, watched an internal Foxconn TV service, shopped at the company supermarkets, and got medical treatment at the compound's Foxconn hospital. Everywhere, there were banners and displays with slogans professing the benefits of working for Foxconn. Even the manholes were stamped with its logo.

Like cloistered nuns and monks, the staff in this compound was for many years shut off from the rest of the world and largely forgotten by the Western media, thanks to Hon Hai's strict control over access. Then, in 2010, a spate of thirteen suicides by workers who were jumping from the top floors of dormitory buildings suddenly thrust unwelcome attention onto this compound, prompting some foreign customers to ponder the *real* cost of the gadgets they buy. The victims' motives were not always made clear, although some left suicide notes apologizing to their families and suggesting a sense of failure in their ambitions. But others tried to speak for them, including the Foxconn worker who posted this statement on a blog after the twelfth suicide: "To die is the only way to testify that we ever lived. Perhaps for the Foxconn employees and employees like us—we who are called *nongmingong*, rural migrant workers, in China—the use of death is simply to testify that we were ever alive at all, and that while we lived, we had only despair."

Hon Hai's first response to the public outrage was to put nets above the concrete floor to catch falling jumpers and to request that workers sign a letter swearing not to take their lives. But it also went on a PR kick, hiring New York firm Burson-Marsteller to spruce up Foxconn's image. The company staged a rally at a stadium inside its sprawling Shenzhen campus to boost morale, with tens of thousands of employees paraded in "I ♥ Foxconn" t-shirts, while Gou personally sponsored tours for select journalists. (This controlled open-door policy lasted only a week or two. My own request for a tour and interview five months later

was turned down.) In these media presentations, Gou announced plans to eventually let workers live independently outside the compound and, most significantly, he raised the basic monthly wage for Shenzhen workers from around \$180 to \$300 a month. Notably, however, he also vowed to start shifting more production to the interior, where wages are lower, to protect his profit margin, and to expand operations overseas. Xui Li said she'd been promised a job in Wuhan, nearer to her hometown, but her boss had been vague about whether she could keep the raise she was due and when the move would take place.

It's unclear whether these reforms will mean more freedom for people such as Xui Li. It's also unclear whether any of these changes will address what are likely the real reasons some of her colleagues chose to end their lives. It's quite possible that morale won't improve without a fundamental overhaul of a business model that hinges on squeezing as much production as possible out of a pliant and dependent workforce. Any student of Chinese history will find something eerily familiar in the way that Hon Hai's Taiwanese owner, sitting inside his own Forbidden City, treats his army of staff.

If we followed all the U.S.-bound iPhones, Dell computers, Nintendo consoles, and other items produced in Foxconn's Longhua plant and similar factories along the Chinese coast to their final destinations, we'd end up crisscrossing the entire landmass of the United States. For more often than not, we'd end up in homes in the suburban areas that surround the country's towns and cities, the heartland of the American middle class. In these places we find the people who represent the American equivalent of the neglected hinterland of China. They too have paid the price for the dysfunctional U.S.-China relationship that enriches city-based elites in both countries.

Here, on Main Street USA, we find the backbone of the U.S. economy. Middle- and lower-income households fueled the boom of the past decade with their spending and then bore the brunt of the bust. They suffered most of the 8 million job losses and the 7 million home foreclosures since 2007. They contributed to the pension and retirement funds that purchased Wall Street's doomed CDOs and other toxic securities before the market tanked and their value plunged. Their taxes backstopped the \$700 billion program to bail out the country's biggest banks and companies in 2008. They provided the soldiers who fought the wars in Iraq and Afghanistan. And even once the economy began recovering from the crisis, they continued to struggle as it failed to add enough jobs to keep up with population growth and kept toying with a return to recession. With home prices still falling, the jobs that disappeared—millions of them in construction—weren't coming back, and people's debts were still exceedingly burdensome.

Yet this suburban base remains vitally important as a market for Foxconn and other Chinese exporters. In 2007, the year before the financial crisis, households earning less than \$150,000 a year accounted for 83 percent of all consumer spending in the United States. In that year also, Americans took on an additional \$70 billion in new credit card debt and \$1.1 trillion in mortgage loans to bring the total amounts outstanding to \$942 billion and \$14 trillion, respectively. That's a total of \$131,000 per household. Without these debt-dependent consumers the international cycle of trade and finance would stop.

Among the tens of thousands of Hewlett-Packard computer components that have passed through Foxconn's Longhua plant's gates were parts that went into a desktop computer that

found a home in Philadelphia. The machine was used to manage the accounts of John DeVlieger, an artist whose classic Italian-style murals were sought after during the housing boom by wealthy hedge fund managers in Connecticut and New York. DeVlieger's income was decent but unpredictable and the burden of legal fees and child support payments from a recent divorce left him short of cash. So in 2006 he decided to tap the equity he held in a small investment property in the working-class Philadelphia suburb of Upper Darby, where a single mother of three kids paid him \$1,200 a month in rent. He'd bought the place for \$100,000 in 2004, but two years later Ameriquest Mortgage, a loan originator, offered him a line of credit worth \$148,500—virtually equivalent to the full appraised value. Given the thin equity buffer and his unpredictable financials, the adjustable-rate loan started with a high 8.5 percent rate and was deemed a subprime mortgage. It was immediately sold to Citigroup, which bundled it into a special investment trust for mortgage-backed securities bearing the acronym CMLTI 2006-AMC1. Whether or not DeVlieger knew that his loan was securitized in this way, he was oblivious to the fact that it brought him within one degree of separation from Fabulous Fab Tourre and his client John Paulson. For it was precisely Paulson's expectation that people such as DeVlieger would default that led the hedge fund manager to choose the CMLTI 2006-AMC1 trust as one of the ninety-two securities incorporated into the Abacus deal.

Soon the housing crisis and recession came. Not only did DeVlieger's art commissions dry up, but his tenant lost her job and fell behind on the rent. "She was in a real predicament. I couldn't kick her out. I didn't even try to," he said. "I tried to renegotiate the mortgage, but that didn't work. So my payments kept on ballooning. It was a house of cards." DeVlieger hung on until 2010, when he finally succumbed to foreclosure. And when the tenant got wind of that she stopped paying altogether. "She really had me over a barrel," he said. A perfectly decent tenant-landlord relationship was destroyed by the bubble created by Wall Street illusionists. And the pain felt by these two people translated directly into pure profit for John Paulson. As soon as people such as DeVlieger started missing payments or seeking to renegotiate their loans, the price of the securities in the Abacus structure plunged, delivering unprecedented capital gains to the hedge fund manager who had made short-selling bets against them.

Many Americans now argue that people such as John DeVlieger got what they deserved. If you and the millions like him who took on zero-down-payment and other high-risk loans should have known their limits and lived within their means, they will say. But while it's true that many borrowers acted irresponsibly, this point of view ignores the systemic factors that led mortgage lenders to provide such large, unaffordable loans and to the public delusion that they viewed this as OK. DeVlieger, who had been a landlord for many years and "had always been pretty selective" about properties, wrongly assumed that real estate would always rise in price. But this "bubble thinking," as Yale economist Robert Shiller calls it, was shared by most Americans at the time. There were many causes of this collective breakdown of logic, and this book will examine some of them, but the key point is to recognize that the causes of the crisis were *systemic*, that they stem from deep-seated structural problems and cannot be solely blamed on rogue financiers or overzealous borrowers. The system—that is to say, the global system—is dysfunctional, and if we don't recognize that and fix the policy framework that makes it that way, we will experience another equally severe crisis. This system is fixed

in favor of a privileged few but is geared against people such as DeVlieger and his tenant, as well as the pension funds that bought the other side of Paulson's Abacus deal; they were the ones left holding the bag when the crunch came. They—and not the U.S. bankers, real estate brokers, and Chinese exporters who inflated the bubbles—paid the biggest price when the crisis made its inevitable arrival. People like them, the ordinary middle and working class of America, China, and other countries, will pay for it again when the next crisis comes.

The divisions created by this discriminatory global system are not confined to the United States and China. The relentless growth of China's export machine is also feeding economic distortions elsewhere. Look no further than the destitute "peripheral" nations of the euro zone—Greece, Italy, Spain, Portugal, Ireland—all desperate to export their way out of a crisis that's roiling the entire global economy. Shackled to an overly strong euro, their products are no match for the cheap products of China and the undervalued yuan, which traps them in a vicious cycle of sliding growth, rising debts, and, ironically, dependence on Beijing for financing. Few countries have ever put so many people around the world through so much change in such a short period of time as China has over the past decade. As it has grown, China has left distinct groups of winners and losers in its wake. Through a more or less random sampling of travel spots, this book will explore examples of each. We will see how workers in Perth, Western Australia, have earned riches they could never have dreamed of thanks to relentless Chinese demand for their state's minerals. But we'll also visit Ciudad Juárez on the U.S.-Mexican border, a town that has become the most violent city on earth in large part because its manufacturing industry failed to compete with the Chinese exporting zeitgeist that entered the U.S. market in 2001. The stark differences between such places illustrate the imbalances of a globalized world in which people's actions in one place reverberate to disrupt lives thousands of miles away. That world is an inequitable, unstable place in which great fortunes can be won or lost depending on how one is placed within it.

Such arbitrary divisions between the privileged and underprivileged are nothing new, of course. The luck of birthright has existed since feudal times. But according to one view of globalization popular for most of the past decade, they were supposed to be disappearing, at least in terms of equality of opportunity. Advanced telecommunications, fast transportation, and enhanced labor mobility, all backed by an improved framework of international law and free trade treaties, were said to be leveling the playing field for global commerce. The world was flat, declared columnist and best-selling author Thomas Friedman in describing a global economy in which nation-states were ceding power to a giant, free-for-all marketplace. According to the Friedman thesis, the winners would be those who sold products or labor of the highest quality and value for money, while those unable or unwilling to innovate, increase productivity, and ascend the value chain would lose. As governments ceased propping up favorite domestic industries, everyone would have to compete on those basic terms. This new hypercompetitive world would be tough, but it would not be discriminatory, and by encouraging a drive for productivity and innovation it would ultimately be a better place.

The global financial crisis and the starkly divided world of winners and losers that emerged in its wake dispelled this myth with brutal force. It showed that although goods, services, and capital markets have indeed gone global, the playing field is far from level—and precisely

because of the distorting role played by a well and truly alive nation-state. Yet even as the financial crisis has exposed an alarming degree of fraud and corruption among those who rode the prior credit bubble to great wealth, pursuing the perpetrators won't in itself fix the problem. The issue here is the failure of our economic and political system, and for that we are all in some way complicit. We—that is to say, those of us with the right to vote, we who live in the wealthy democratic societies of the West—have let the few who thrive from the failing system use their financial resources to manipulate our electoral process and block any serious reforms to it. Until we destroy the scourge of money politics, our democracies will fall short of their rule-by-majority promise, ensuring that our societies become increasingly divided and economies more unstable.

According to the neoliberal dogma on deregulation and privatization that held sway after the end of the Cold War and informed Friedman's thesis, there was little wrong with the economic inequities that later propelled those who participated in the Occupy movement into the streets of the world's capitals. Wealth disparities were part and parcel of a more efficient free market system, one that was forcing the global economy into a survival-of-the-fittest process of evolution. By neoliberalism's own internal logic, if you intervened in that system, you would hold back the advance of human prosperity.

But this view failed to recognize that the "free market system" is not free at all. The global economy is unbalanced, fraught with massive distortions, inefficiencies, and inequities, most of which arise directly from government policies—sometimes from too much regulation, other times from too little. Each flawed policy is a problem in itself, but worse is the damage done by their misalignment with one another. A global matrix of mismatched, distorting policies lies at the heart of many of our economic problems. These distortions, and not some Darwinistic process that weeds out laziness or incompetence, are the major reason why in 2010 America's wealth gap was at its widest level in eight decades.

Yet few see this picture. Instead, many blame international inequities on supposed flaws in national character—on Americans' rampant consumerism or on the sloth of the Greeks and Italians. But while no one can dispute that Americans must learn to live within their means—indeed, circumstances are now forcing them to—or that Greece and Italy need structural reforms that ensure that hard work is rewarded, it's dangerous to view these countries' problems in isolation from the policy distortions that shape the global financial system. It might be easier to understand the crisis as some kind of retribution for an era of wanton excess, but such moralizing won't shape effective policy making. The solution requires a wholesale change in the way the global economy is structured. Without that, the arrival of a more frugal U.S. consumer will only add more hardship.

A good place to start is the price of credit, the mechanism through which America's and Europe's debt has ballooned. For too long, debt was mispriced. It was given too high a value by creditors, the corollary of which meant that borrowers paid too little. Yes, greed and naïveté contributed to the mania for U.S. subprime mortgages and for investment homes in places like Spain and Ireland, but the financial bubble would not have been possible without the fundamental mispricing of debt caused by the interplay of poorly designed policies from different governments around the world.

It's a central tenet of economics—and certainly one that the neoliberal reformers subscribed

to—that if you mess with prices you undermine the market’s capacity to allocate resources where they are most needed. There are sometimes good reasons to intervene in that process and create positive incentives—to steer funds toward infrastructure, education, or health services, for example—but if price distortions happen on a systemic, economy-wide basis, the growing mismatch between demand and supply eventually produces a crisis. These price distortions can arise because government regulations favor certain industries and firms or conversely, because a failure to enforce pro-competition regulations allows private monopolies to undermine the free market. Either way, we end up with perverse incentives so that people consistently make economic decisions that lead to suboptimal economic results for all. Case in point: the failure of the Soviet Union’s centrally priced economy. Something similar happened to the entire world before the crisis. We had integrated our economies to an unprecedented degree, but by leaving in place all these misaligned policies, prices, and incentives, we misallocated resources and created an inherently unstable financial environment. Integration is indeed the route to prosperity, but it needs coordination to ensure efficiency.

In China, the undervaluation of the yuan, low interest rates, and savings-inducing social policies reduced the cost of entry into manufacturing and created an overwhelming incentive for Chinese businessmen to focus on exports rather than domestic consumers. In the United States, the overpricing of bank assets encouraged excessive risk taking, all because of the unspoken “too-big-to-fail” doctrine, with which the government implicitly guaranteed to bail out banks if they fell into trouble. This in turn left the U.S. economy dangerously dependent on a continued credit-fueled expansion in household spending. And in the euro zone, a similarly overprotected banking system operating under a one-size-fits-all monetary policy severely mispriced the value of government debt to stoke a credit boom that disguised the region’s internal imbalances. To a large extent, these policy distortions can be traced to the twin trends that I’ve loosely grouped into the two parts of this book: the rise of China as a world economic force, and the emergence of a powerful, underregulated, and globalized financial sector. Together, these tectonic shifts have put the world economy off-kilter.

The imbalances have reached a point where the previous dichotomy, one in which China and other developing countries manufactured stuff and the rest of the developed world bought it, cannot last. As they gradually reduce their overinflated debt by selling assets in a multiyear “deleveraging” process, U.S. and European societies will inevitably face a continued slowdown in spending. These advanced economies’ consumers are not the pot of gold they were for developing countries’ producers and will themselves depend on exports to spur growth. To get the world back to equilibrium, then, policy incentives must change so that Chinese save less, Americans save more, and Europeans sort out their intra-continent savings and spending mismatches. If we fail to achieve this rebalancing, the eventual outcome could be devastating: trade conflicts, social upheaval, even revolutions and wars. In an era in which peaceful democracy appears to be ascendant, and where open trading systems are protected by the World Trade Organization, such conflicts might seem like distant prospects. But in the grand sweep of human history, they are common.

The problem is that no side will change on its own for fear that others will freeload. The only way forward lies in multilateral agreements reached through forums such as the Group of 20 developed and developing nations and the International Monetary Fund. Yet for

national governments to engage with one another in this way, they too need to be properly incentivized. They will seek to change the status quo only if they are under effective political pressure to do so—if ordinary people like you and me demand it.

Throughout my conversations with people affected by the financial crises of recent years, I encountered a profound, worldwide loss of trust in our political and economic institutions. The disturbing conclusion I draw from this is that we are losing faith in our collective ability to form governments that will represent the collective will of the people. That marks a depressing departure from the optimistic, if often misguided, utopianism of decades past. It also poses a serious threat to free market capitalism, a system that, for all its flaws, has until now proven to be the most effective in fostering and perpetuating human prosperity. A functioning capitalist system depends on people's trust and confidence: trust that the law will protect their contractual and property rights, trust in the currency in which they save, and confidence in a stable future. Without trust and confidence, people don't invest in risk-bearing assets. And that means that businesses are denied a flow of funding that's needed to permit growth.

In movements as disparate as Occupy Wall Street, the U.S. Tea Party, and the Arab Spring, we find evidence of people seeking to force political change for what they see as the better. And that should be encouraging. But for most of them, the focus is on attacking existing institutions rather than building better new ones. Equally important, few of these protests are focused on what must happen at the international level. Our societies need to take the next step and do so in concert with one another. It's an enormous challenge, but if we don't find a way to collectively reform our broken global financial system, the next decade looks bleak.

You don't need to hear it from me. In the pages that follow, ordinary people will, like Scott, give voice to their fears, hopes, and dreams and so demonstrate how our existing global system is untenable. Taken together, their stories should also make it clear that whichever way things go from here, we are all in this together.

PART ONE

The Rise of China

Origins of Dysfunction: How We Got Here

Richard Nixon was the accidental architect of our current global financial system. This makes him the ideal starting place for getting a grip on the dysfunctional nature of the world economy. In the late 1960s and early 1970s, outlays for the Vietnam War were playing havoc with the finances of the U.S. government. The trade deficit was expanding monthly as American consumers gravitated toward cheap new imports from Europe and Japan. A growing band of nervous foreign investors began exchanging their dollar reserves for gold, driving U.S. gold holdings down to dangerously low levels. President Nixon felt trapped by an economic juggernaut he could not control.

So, on August 5, 1971, Nixon gave a televised address to the American people. Its significance was likely lost on most of his audience, but it hit like an earthquake in the halls of the world's banks. Looking solemnly into the camera, the president began by speaking gravely about an "all-out war" waged by "international money speculators" against the United States. Then, as he vowed without a trace of irony to protect the dollar "as a pillar of monetary stability around the world," Nixon let it be known that he had instructed Treasury Secretary John Connally to suspend the dollar's convertibility into gold. With those words the Bretton Woods system, a regime that had maintained global monetary stability since the end of World War II, was finished. The amount of dollars in circulation would no longer be backed by the requirement that the Federal Reserve hold the equivalent value in gold, an arrangement that had made the greenback an anchor for every currency in the world. Nixon described the measure as "temporary" and vowed to work with the International Monetary Fund (IMF) and America's trading partners to create "an urgently needed new international monetary system" that would ensure "stability and equal treatment." But these pledges proved impossible to fulfill. A year and a half later, the major currencies of the world had delinked from the dollar and were now free-floating. The end of the gold backing became permanent, and no coordinated global currency system was ever established again.

The "Nixon Shock," as it became known, had profound, far-reaching consequences. It allowed money and credit to flow more freely across borders, which meant that economic growth rates accelerated. But it also meant that financial volatility and instability rose dramatically and that financial institutions garnered more power. The dramatic end to the Bretton Woods system transformed the global economy, setting it on a path to its current unbalanced state.

Gold: Stabilizer or Straitjacket?

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