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

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To Zoe and Analia

CONTENTS

The View from James Street

I have a neighbor across the street in Pelham, New York, whose good humor, intelligenc and well-stocked collection of single-malt scotch make him an ideal companion with whom t mull over the world’s problems. An avid and thoughtful reader, Scott would repeatedly te me that he hoped my book would give him reassurance. He wanted to be convinced tha after the financial turmoil and political uncertainty that have characterized America’s rece 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 request for optimism was a tough ask. Still, I did respond by laying out what I saw as some the hopeful signs of progress that globalization has delivered. There was the fact, fo example, that between 1990 and 2005 the number of people living on less than $1.25 a da dropped by 400 million, putting the world on track to far surpass the UN’s Millenniu Development Goal of halving the rate of extreme poverty between 1990 and 2015. Or the was the seven-year increase in life expectancy from 1990 to 2010, the 47 percent decline infant mortality over the same period, or the 11-point rise in literacy rates to 84 percent fo people age fifteen and over. The relentless advance of a 1.3-billion-strong China over th time disproportionately pushed up the aggregate results, but this newfound upward mobili is truly a global phenomenon. It has spread across Asia, Latin America, and Eastern Europ Even sub-Saharan Africa, the forgotten continent, is posting gains, with growth rat averaging 4 percent over the past four years and social indicators in health, education, an general development all showing real improvements since 2000. On an international leve Adam Smith has been largely proven right: free trade and integration led to greater and mo efficient production of goods and services for all.

Yet it’s hard for Scott and hundreds of millions of Westerners like him to fully apprecia 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 financi crisis, the likes of which had not been seen in eighty years. And just three years later, with new crisis rocking Europe, it was facing another bout of financial turmoil, this one potential even more destructive than the previous one. These crises have shown that many of the jo created before them were transitory, especially in the bubble-economics sectors of financi services, real estate, and residential construction. In the United States, where inflatio adjusted data show household income dropping 7.1 percent from 1999 to 2010 and th median wage of male workers unchanged from 1968, inequality widened to levels not see since 1928, the year that preceded the Great Depression. The top 1 percent of earne received 21 percent of the nation’s total income in 2008, up from 9 percent in 1976, aft having accounted for a whopping four-fifths of all income gains between 1980 and 200 Globalization and the Internet have allowed U.S. labor productivity to increase on averag about 3 percent per year since 1995, but the income gains from that improved efficiency hav flowed almost entirely to the upper echelons of American wealth. Although everyone's li has been enriched to some extent by a greater abundance of affordable goods and b exponential developments in communications and medical technology, the majority ha slipped enormously in relative terms. Yet even that disparity could be rationalized into som concept of an improved overall quality of life if it weren't for a new element that these crise have introduced: a profound sense of uncertainty about the future.

I traveled widely to research this book, and from one continent to another I encountere people who'd lost their faith in political and financial institutions. I heard it from bankru homeowners in different parts of the United States, from underinsured laborers in souther China, from terrorized factory workers in Ciudad Juárez, Mexico, from rent-choked retaile in Hong Kong, from duped savers on the Channel Island of Guernsey, and from th unemployed of the Costa del Sol and Reykjavik. And it's not just among these hardest-h 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 o somewhat unlikely" that their children would enjoy a standard of living better than their Worldwide, this emotional reaction has manifested both in a backlash against the politic establishment and in deep divisions within that establishment. It is reflected in the politic advances of nationalist anti-euro movements in Finland and other parts of Europe, while th governments of the United Kingdom, Germany, Ireland, Greece, Portugal, the Netherland and Belgium all struggled to sustain parliamentary majorities. It is also apparent in the rise o both the U.S. Tea Party and the Occupy Wall Street movement, as well as in th uncompromising Washington partisanship that let the credit rating of the world's bigge economy fall victim to what looked to the rest of the world like a schoolyard brawl. Th divisions that threatened to turn the 2012 U.S. presidential election into a bitter class batt stem from this discontent.

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

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

Who can dispute that viewpoint? Here's a decent, hardworking man who seeks the securi of the status quo, not a bigger piece of the pie. He's not greedy. His greatest desire is ensure that his child has the same opportunities he had. And how is that any different fro me? My wife and I chose to live in Pelham because its schools offered the best we coul afford for our daughters. So much for integrating with the world; Pelham isn't eve integrated with neighboring Mt. Vernon and the Bronx, where incomes are lower, the schoo have fewer resources, the crime levels are higher, and the life prospects for children a poorer. This is our deliberate choice. I can make all the high-minded analyses I like about th benefits of globalization, but my priorities are also based on what's best for my immedia family, on what happens at the local level. Don't we all view the world from our ow versions of James Street?

Here lies the crux of the challenge ahead. Globalization is an unstoppable train. Even if w wanted to return to a world of protectionism and high tariffs, or if a political backlash led t the dissolution of the World Trade Organization (WTO), the modern intricacies of glob supply chains make such a return nearly impossible. And yet the instinct to resist th disruptive changes that come with greater integration is strong. We all feel it to some exten and so unwittingly act as agents of the distorting policies that protect the dysfunctional statu quo. It has always been so. Throughout modern history, technological change and th accompanying expansion in human capability have run up against an instinctiv conservativism, leaving our social, political, and legal structures ill-prepared for these ne realities. (Think of how ethical boundaries have persistently been challenged by scientific an medical advances over time—from Galileo to stem cell technology.) This, at its core, is wh Europeans were grappling with as their debt crisis came to a crunch moment in late 201 Their financial markets had computerized and globalized so rapidly that they now operated an *international* sphere where time and distance were no longer a barrier to commerce. B their politics—and therefore the financial regulatory apparatus deployed to manage thos markets—were anchored in older institutions that intrinsically protected *national* interest This mismatch, a product of the same, innate resistance to sweeping change that Scott and both experience, left Europeans inadequately prepared for the financial maelstrom into whic they were hurled. Americans and other non-Europeans are by no means immune from suc breakdowns either. As we will see in the pages ahead, tensions between forward-marchin globalization and stagnating national politics are on the rise everywhere. My goal is demonstrate how, in hanging on to a nonintegrated political status quo, we have failed stop a powerful, globalized financial system from working against our common interest. doing so, I hope to encourage readers to overcome this conservative instinct and push f 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 pow of global finance must first recognize the deep-seated human resistance to the changes th would entail. Such fear of the new is not something to be belittled or caricatured backwardness. It is founded on nothing less than the dreams we hold for our children. W must give people reasons to hold on to such hopes. And yet it's fair to say that these w 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 Bun Shanghai's elegantly restored colonial district, and gaze across the Huangpu River at th spectacular Pudong skyline on the other side. When I look at it—and quite likely if Sco 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 o
the Oriental Pearl Tower drawing the eye, the scene is reminiscent of Toronto, with i
dominating CN Tower. But I can't help but compare it to lower Manhattan's skyscraper
Why? Because both skylines are culturally entrenched symbols of what the future might hol
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
the twentieth century was Manhattan's skyline. Then a group that detested that power soug
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 progres
Compared to the speed with which Shanghai was relentlessly reaching for the sky, the lo
delays in the construction of 1 World Trade Center, aka the Freedom Tower, seemed
symbolize a decline in American power. (That a China-based manufacturer was awarded th
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 bigg
economic crisis, teams of immigrant construction workers took just one year to build th
Empire State Building from U.S.-produced materials. That aptly named accomplishme
staked America's claim on the twentieth century. More recently, however, the hole that th
fallen Twin Towers left in the Manhattan skyline hinted that this claim wouldn't be renewe
for the twenty-first century.

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

But like any symbolic reading, this assessment of the two cities misses the nuances o
reality. With a bit more information, one can compose an equally compelling story that pu
the two skylines in a symbiotic relationship. The industries that drive Shanghai and New Yor
are interlinked via the trade and financial flows that arise within the China-U.S. econom
partnership. The Shanghai of the twenty-first century was built upon the wealth generated b
China's exporting colossus, which depends on consumers in the U.S. market. Because o
China's exchange rate and monetary policies, as well as other rules that limit how muc
wealth trickles down to its 1.3 billion citizens, the export machine creates an ever-growin
pool of dollar-based savings. A large part of those savings is commandeered by the People
Bank of China, which then transfers it to the U.S. government in return for its bonds. In a
indirect but very significant way, that money helps sustain the securities trading business
that keep New York's lights on. It's not for nothing that the city's real estate prices held u
while homes across the rest of the United States plunged in value after the 2008 crisis. No
should it be surprising that after $24 billion had been spent on reconstruction, the are

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

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

This coast-versus-hinterland dichotomy in both China and the United States is exhibit A our case for showing how the wide gaps in opportunities for people in different circumstanc around the world reflect a fundamental failing in the structure of the global economy. we'll learn, it all comes down to how policies set in Washington, Beijing, and other politic capitals combine to create a dysfunctional global financial system that provides the bigge 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 th weak exchange rate policy and the general pro-export orientation of China's economic mode Gou grew up poor in Taipei, but with a $7,500 starter loan from his mother in 1974 he ro the China boom to personal wealth of $5.7 billion in 2011, according to *Forbes*. Now th highest-profile member of a new breed of cross-Taiwan Strait businessmen, his company, H Hai Industries, better known by its trade name Foxconn, produces more of the world consumer electronic products than any other. It has factories in ten locations in China a additional plants in six other developing countries, employing a total staff of almost million. That's more people than are on the payrolls of Apple, Dell, Microsoft, Hewle Packard, Intel, and Sony put together. Indeed, Foxconn work teams churn out products f many of those marquee names. The reclusive Gou keeps his official residence in Taipei but spends much of his time at Foxconn's Longhua manufacturing compound in Shenzhen, whe 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 other things, including shopping for $30 million castles in the Czech Republic and pursui his passion for tango dancing.

In 2010, Hon Hai Industries generated a staggering $95.19 billion in revenues, the va bulk of it earned overseas. That's about $260 million a day, Terry Gou's own contribution the money flows that prop up a dysfunctional world financial system. Until laws requiri exporters to repatriate their foreign earnings were relaxed in late 2010, these earnings a those of many other Chinese exporters would automatically return to China, along wi billions more every day from thousands of other exporters, dollars that the fixed excha rate policy of the People's Bank of China (PBOC) compelled it to acquire. Even after tho 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 th time of writing, the yuan had risen by about 7.3 percent against the dollar in the eightee months that had passed since the central bank ended a two-year policy of rigidly fixing th exchange rate and began making tiny daily upward adjustments to it. Then, at the end o 2011, with the global economy entering another slowdown, yuan inflows eased an sometimes even turned to outflows as investors speculated that the government woul abandon the appreciation policy, just as it had during the recent global economic crisis. Bu although there were varying opinions about the yuan's fair value, analysts generally agree that the Chinese currency was still considerably undervalued against virtually all of i trading partners' currencies. The fact that the PBOC added about $1 trillion in reserves durin the period of appreciation was proof of undervaluation and therefore of a mercantilist polic that's deliberately intended to support Chinese exporters.

Intervention on such a scale has sweeping global implications. C. Fred Bergsten, th director of the Peterson Institute for International Economics, called it the "large 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 undervalue and a European or U.S. recession that hurts Chinese exports could hasten that moment. Bu the global distortions created by the interventions of the past decade will take many, man years to undo.

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

Even though its power has waned slightly, the gargantuan Chinese export sector's revenu produced an average trade surplus of around $13 billion a month in 2011, or just under $75 million per business day. Those foreign earnings, along with inflows from approved foreig investors in land, plant, and machinery, as well as from any foreigner who can get around th government's strict capital controls to speculate on Chinese financial instruments, meant th 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 fro pushing up the local currency's value beyond its tightly managed exchange rate target. To pa for those purchases without pumping new inflation-stoking yuan into the economy, th central bank issued yuan-denominated bonds to Chinese banks, which were flush with cas deposits drawn from China's enormous store of household and corporate savings. Afte effectively converting these savings into foreign currency, the PBOC then had to decid where to invest it overseas. By mid-2011, accumulated reserves hit $3.2 trillion as o September 30, 2011. There simply aren't enough foreign markets big or liquid enough t ensure that prices don't tip against such a central bank when it buys or sells, and that ar legally stable enough to protect future transactions. Thus the PBOC typically, albe reluctantly, steered most of its money into U.S. Treasuries, the bonds of the world's ma 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 occurre in December, but there were also hints before then that Chinese banks were being told t hold onto dollars rather than sell them to the PBOC. If it accepted those dollars, the Chines central bank would have had to gorge itself even more on Treasuries, and by then it wa suffering indigestion.

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

While there are many other sources of demand for U.S. Treasuries, the marginal effect o China's purchases is so large that it can't help but support U.S. bond prices. That in turn kee down the yield that investors earn on those securities. (By definition, yields move in invers relation to prices on bonds and other fixed-income securities.) Over time, this has allowed th United States to roll over its enormous calendar of expiring debt at dirt-cheap borrowi rates—which hit a record low of 1.67 percent for ten-year bonds in September 2011. I effect, China is an enabler of America's debt accumulation and its steep fiscal deficit, whic the Congressional Budget Office projected to reach 8.5 percent of gross domestic produ (GDP) in 2011. The cross-Pacific savings flows—and, more broadly, the privilege o controlling the world's reserve currency—encourage political short-termism in the Unite States, which means that reforms urgently needed to bring down the country's long-ter deficits are postponed. It was disturbing how little attention was focused on this internation aspect of America's debt problem during the rancorous debt ceiling debate that resulted in th ignominious downgrading of America's credit rating by Standard & Poor's. A debate that wa reduced to overly simplistic mantras—"taxes kill growth" from the right, "Social Securi can't be touched" from the left—ignored the elephant in the room. America's debt challeng 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 whic its holdings are concentrated. Yet by entering into what can only be described as codependent relationship, Beijing is helping to foster the kind of U.S. fiscal problems it mo fears. China cannot be blamed for an irresponsible budget process, but the fact is that th perpetual demand for U.S. government bonds created by its excess savings and manage exchange rate policy makes it easier for Washington to put off the hard decisions. Withou 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 o government debt will force politicians' hands on tough decisions—as with Greece, Irelan

Portugal, and Spain's adoption of tough austerity measures during the recent euro zon 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 fo pricing every other form of credit, their rising prices and falling yields ripple throug America's financial markets, pushing investors to seek better deals on higher-yielding de securities. That brings down interest rates on other loans and creates temptations fo borrowers. It also fires up the kinds of factories in which New York specializes: bond tradin desks.

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

With demand from China's and other countries' central banks driving up the price of AA 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 de eagerly turned to these newfangled securities as substitutes. In the process, they delivered river of fees to the Wall Street banks that designed them and to the ratings agencies that gav them their AAA stamp. As the CDO factory cranked up, it absorbed more and more mortgag into the securitization process, which freed up capital at the originating banks, allowing the to go out into suburban neighborhoods and recruit still more home loan clients. Most peop saw it as a perfect, virtuous cycle that was fast-tracking the country to universal hom ownership. Only as time went on did a few Wall Street insiders, their clients, and some savv academics recognize that the system was a ticking time bomb.

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

"Fabulous Fab." Written just before the financial crisis took root, his email read, "The who building is about to collapse anytime now.... Only potential survivor, the fabulou Fab … standing in the middle of all these complex, highly leveraged exotic trades he create 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 employer. In a case that Goldman settled out of court for a record $550 million, the SE charged that in 2007, right at the top of the housing boom, Tourre knowingly assemble complex "synthetic" CDOs whose derivative-based structure was founded on dubiou mortgages, and then passed them off to naive investors as if they were low-risk securitie Meanwhile, the SEC said, a better-informed and more privileged client used the sam investment vehicle, which Goldman had named Abacus, to place short-selling bets against th securities. Months later, that client, hedge fund manager John Paulson, made $1 billion f his Manhattan-based firm Paulson & Co. when waves of defaults started hitting the subprim mortgages inside the Abacus structure. It was a crowning moment in a year-long spree of be against the housing bubble that earned Paulson & Co. a staggering $15 billion. Paulso himself took home $4 billion that year, catapulting him to sixth place on *Forbes* magazine list of America's richest people. For his part, the then-twenty-eight-year-old Tourre earned $2 million bonus. After paying a mere $4,000 a month in rent for his Greenwich Villag apartment, Tourre could devote his winnings to other pursuits, including what his neighbo described as wild, all-night parties. Once the crisis hit, Tourre moved to Goldman's Londo unit. But after the SEC investigation broke in the spring of 2010, he was put o administrative leave. He continued to receive his salary and benefits while Goldman paid h legal fees in a case that was to leave the Frenchman, remarkably, as the only individual fro 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 invariab reside in the big trade and financial centers on either country's coasts, the laborers an consumers who support the transnational enterprise often come from places farther inlan The way this deal has played out, it has left the skyscraping city as the victor and th hinterland as the loser.

Economic advancement does not come free. And in China, the heaviest price has bee disproportionately paid by inhabitants of the rural interior and their single-child offsprin 220 million of whom have left home in recent years to work grueling shifts in coastlan factories. These people, known as the "floating population" because they fall outside China strict provincial system of residency, have their eyes on a brighter future. And eventually th may come to their children or grandchildren. But it need not be such a long, arduous path prosperity. These people are better-off than they were in their villages, but that's not sayin much. And throughout the boom of the past two decades, various discriminatory polici ensured that China's working-class majority has subsidized the well-connected minority th controls its export business. Due to a fixed, undervalued exchange rate, a set of rules th explicitly limit migrant laborers' access to education, health services, and social security, an a closed banking system, workers saw their purchasing power restrained and their investin options limited. Bereft of state support for retirement or health needs, these people and th 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, the contribute to a growing pool of funds that's used to finance the export machine deliberately repressed interest rates. As Peking University professor Michael Pettis describ 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, lov and family to save for the future while their employers become rich on their labor and the underremunerated savings. Born in a small village in Hubei province, Xui Li moved Shenzhen in 2010, where, when I met her, she was working and living in the Longhu headquarters of Terry Gou's Foxconn plant—together with 300,000 others. Occupying almo an entire square mile, the sprawling, enclosed compound is a city unto itself. Inside, lines th would distinguish Xui Li's private life from her work life were blurred. Most of her wakin hours were spent before a stream of semiassembled Hewlett-Packard printers, into which sh snapped the internal belts that drive their cartridges. Putting in ten-hour shifts, she said h team assembled 2,400 separate units each day. She worked six days a week and earned 1,20 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 compoun only once a week—on Sunday, her day off, which is when I encountered her among hundred of young men and women streaming out of the entrance of the Foxconn headquarters Shenzhen. She slept in a bunk bed in a female-only dormitory, ate virtually every meal in on of many cavernous cafeterias in the compound, and even spent her social time attendin Foxconn-sponsored events. She wore the same uniform as everyone else, watched an intern Foxconn TV service, shopped at the company supermarkets, and got medical treatment at th compound's Foxconn hospital. Everywhere, there were banners and displays with slogan professing the benefits of working for Foxconn. Even the manholes were stamped with i logo.

Like cloistered nuns and monks, the staff in this compound was for many years shut o from the rest of the world and largely forgotten by the Western media, thanks to Hon Hai strict control over access. Then, in 2010, a spate of thirteen suicides by workers who wer jumping from the top floors of dormitory buildings suddenly thrust unwelcome attention ont this compound, prompting some foreign customers to ponder the *real* cost of the gadgets the buy. The victims' motives were not always made clear, although some left suicide note apologizing to their families and suggesting a sense of failure in their ambitions. But othe tried to speak for them, including the Foxconn worker who posted this statement on a blo after the twelfth suicide: "To die is the only way to testify that we ever lived. Perhaps for th Foxconn employees and employees like us—we who are called *nongmingong*, rural migra workers, in China—the use of death is simply to testify that we were ever alive at all, an 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 catch falling jumpers and to request that workers sign a letter swearing not to take the lives. But it also went on a PR kick, hiring New York firm Burson-Marsteller to spruce u Foxconn's image. The company staged a rally at a stadium inside its sprawling Shenzhe campus to boost morale, with tens of thousands of employees paraded in "I ♥ Foxconn" shirts, while Gou personally sponsored tours for select journalists. (This controlled open-do policy lasted only a week or two. My own request for a tour and interview five months lat was turned down.) In these media presentations, Gou announced plans to eventually l workers live independently outside the compound and, most significantly, he raised the bas monthly wage for Shenzhen workers from around $180 to $300 a month. Notably, howeve he also vowed to start shifting more production to the interior, where wages are lower, protect his profit margin, and to expand operations overseas. Xui Li said she'd been promise a job in Wuhan, nearer to her hometown, but her boss had been vague about whether sh 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 also unclear whether any of these changes will address what are likely the real reasons som of her colleagues chose to end their lives. It's quite possible that morale won't improv without a fundamental overhaul of a business model that hinges on squeezing as muc production as possible out of a pliant and dependent workforce. Any student of Chine history will find something eerily familiar in the way that Hon Hai's Taiwanese owner, sittin 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 iten produced in Foxconn's Longhua plant and similar factories along the Chinese coast to the final destinations, we'd end up crisscrossing the entire landmass of the United States. Fa more often than not, we'd end up in homes in the suburban areas that surround the country towns and cities, the heartland of the American middle class. In these places we find th people who represent the American equivalent of the neglected hinterland of China. They to have paid the price for the dysfunctional U.S.-China relationship that enriches city-base elites in both countries.

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

Yet this suburban base remains vitally important as a market for Foxconn and othe Chinese exporters. In 2007, the year before the financial crisis, households earning less tha $150,000 a year accounted for 83 percent of all consumer spending in the United States. I 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-depende consumers the international cycle of trade and finance would stop.

Among the tens of thousands of Hewlett-Packard computer components that have passe through Foxconn's Longhua plant's gates were parts that went into a desktop computer th found a home in Philadelphia. The machine was used to manage the accounts of Joh DeVlieger, an artist whose classic Italian-style murals were sought after during the housi boom by wealthy hedge fund managers in Connecticut and New York. DeVlieger's incom was decent but unpredictable and the burden of legal fees and child support payments from recent divorce left him short of cash. So in 2006 he decided to tap the equity he held in small investment property in the working-class Philadelphia suburb of Upper Darby, where single mother of three kids paid him $1,200 a month in rent. He'd bought the place f $100,000 in 2004, but two years later Ameriquest Mortgage, a loan originator, offered him line of credit worth $148,500—virtually equivalent to the full appraised value. Given the th equity buffer and his unpredictable financials, the adjustable-rate loan started with a high 8 percent rate and was deemed a subprime mortgage. It was immediately sold to Citigrou which bundled it into a special investment trust for mortgage-backed securities bearing t acronym CMLTI 2006-AMC1. Whether or not DeVlieger knew that his loan was securitized this way, he was oblivious to the fact that it brought him within one degree of separati from Fabulous Fab Tourre and his client John Paulson. For it was precisely Paulso expectation that people such as DeVlieger would default that led the hedge fund manager choose the CMLTI 2006-AMC1 trust as one of the ninety-two securities incorporated into t Abacus deal.

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

Many Americans now argue that people such as John DeVlieger got what they deserved. H and the millions like him who took on zero-down-payment and other high-risk loans shou have known their limits and lived within their means, they will say. But while it's true th many borrowers acted irresponsibly, this point of view ignores the systemic factors that l mortgage lenders to provide such large, unaffordable loans and to the public delusion th viewed this as OK. DeVlieger, who had been a landlord for many years and "had always bee pretty selective" about properties, wrongly assumed that real estate would always rise price. But this "bubble thinking," as Yale economist Robert Shiller calls it, was shared b most Americans at the time. There were many causes of this collective breakdown of log and this book will examine some of them, but the key point is to recognize that the causes the crisis were *systemic*, that they stem from deep-seated structural problems and cannot b solely blamed on rogue financiers or overzealous borrowers. The system—that is to say, t global system—is dysfunctional, and if we don't recognize that and fix the policy framewo that makes it that way, we will experience another equally severe crisis. This system is fix in favor of a privileged few but is geared against people such as DeVlieger and his tenant, a well as the pension funds that bought the other side of Paulson's Abacus deal; they were th ones left holding the bag when the crunch came. They—and not the U.S. bankers, real esta brokers, and Chinese exporters who inflated the bubbles—paid the biggest price when th 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 State and China. The relentless growth of China's export machine is also feeding econom distortions elsewhere. Look no further than the destitute "peripheral" nations of the eur zone—Greece, Italy, Spain, Portugal, Ireland—all desperate to export their way out of a cris that's roiling the entire global economy. Shackled to an overly strong euro, their produce are no match for the cheap products of China and the undervalued yuan, which traps them a vicious cycle of sliding growth, rising debts, and, ironically, dependence on Beijing fo financing. Few countries have ever put so many people around the world through so muc change in such a short period of time as China has over the past decade. As it has grow China has left distinct groups of winners and losers in its wake. Through a more or le random sampling of travel spots, this book will explore examples of each. We will see ho workers in Perth, Western Australia, have earned riches they could never have dreamed thanks to relentless Chinese demand for their state's minerals. But we'll also visit Ciuda Juárez on the U.S.-Mexican border, a town that has become the most violent city on earth large part because its manufacturing industry failed to compete with the Chinese exportin zeitgeist that entered the U.S. market in 2001. The stark differences between such plac illustrate the imbalances of a globalized world in which people's actions in one plac reverberate to disrupt lives thousands of miles away. That world is an inequitable, unstab 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, course. The luck of birthright has existed since feudal times. But according to one view globalization popular for most of the past decade, they were supposed to be disappearing, least in terms of equality of opportunity. Advanced telecommunications, fast transportation, and enhanced labor mobility, all backed by an improved framework international law and free trade treaties, were said to be leveling the playing field for glob commerce. The world was flat, declared columnist and best-selling author Thomas Friedma describing a global economy in which nation-states were ceding power to a giant, free-for-a marketplace. According to the Friedman thesis, the winners would be those who so products or labor of the highest quality and value for money, while those unable or unwillin to innovate, increase productivity, and ascend the value chain would lose. As governmen ceased propping up favorite domestic industries, everyone would have to compete on thos basic terms. This new hypercompetitive world would be tough, but it would not b discriminatory, and by encouraging a drive for productivity and innovation it woul ultimately be a better place.

The global financial crisis and the starkly divided world of winners and losers that emerge in its wake dispelled this myth with brutal force. It showed that although goods, services, an capital markets have indeed gone global, the playing field is far from level—and precise because of the distorting role played by a well and truly alive nation-state. Yet even as th financial crisis has exposed an alarming degree of fraud and corruption among those wh rode the prior credit bubble to great wealth, pursuing the perpetrators won't in itself fix th problem. The issue here is the failure of our economic and political system, and for that w are all in some way complicit. We—that is to say, those of us with the right to vote, we wh live in the wealthy democratic societies of the West—have let the few who thrive from th failing system use their financial resources to manipulate our electoral process and block an serious reforms to it. Until we destroy the scourge of money politics, our democracies wi fall short of their rule-by-majority promise, ensuring that our societies become increasing divided and economies more unstable.

According to the neoliberal dogma on deregulation and privatization that held sway after th end of the Cold War and informed Friedman's thesis, there was little wrong with th economic inequities that later propelled those who participated in the Occupy movement in the streets of the world's capitals. Wealth disparities were part and parcel of a more efficie free market system, one that was forcing the global economy into a survival-of-the-fitte process of evolution. By neoliberalism's own internal logic, if you intervened in that syster 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 glob economy is unbalanced, fraught with massive distortions, inefficiencies, and inequities, mo of which arise directly from government policies—sometimes from too much regulatio other times from too little. Each flawed policy is a problem in itself, but worse is the damag done by their misalignment with one another. A global matrix of mismatched, distorti policies lies at the heart of many of our economic problems. These distortions, and not som Darwinistic process that weeds out laziness or incompetence, are the major reason why 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 national character—on Americans' rampant consumerism or on the sloth of the Greeks an 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 structur reforms that ensure that hard work is rewarded, it's dangerous to view these countrie problems in isolation from the policy distortions that shape the global financial system. might be easier to understand the crisis as some kind of retribution for an era of wanto excess, but such moralizing won't shape effective policy making. The solution requires wholesale change in the way the global economy is structured. Without that, the arrival of 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 an Europe's debt has ballooned. For too long, debt was mispriced. It was given too high a valu by creditors, the corollary of which meant that borrowers paid too little. Yes, greed an naïveté contributed to the mania for U.S. subprime mortgages and for investment homes places like Spain and Ireland, but the financial bubble would not have been possible witho the fundamental mispricing of debt caused by the interplay of poorly designed policies fro different governments around the world.

It's a central tenet of economics—and certainly one that the neoliberal reformers subscrib to—that if you mess with prices you undermine the market's capacity to allocate resources t where they are most needed. There are sometimes good reasons to intervene in that proce and create positive incentives—to steer funds toward infrastructure, education, or heal services, for example—but if price distortions happen on a systemic, economy-wide basis, th growing mismatch between demand and supply eventually produces a crisis. These pric distortions can arise because government regulations favor certain industries and firms o conversely, because a failure to enforce pro-competition regulations allows priva monopolies to undermine the free market. Either way, we end up with perverse incentives s that people consistently make economic decisions that lead to suboptimal economic resul for all. Case in point: the failure of the Soviet Union's centrally priced economy. Somethin similar happened to the entire world before the crisis. We had integrated our economies to a unprecedented degree, but by leaving in place all these misaligned policies, prices, an incentives, we misallocated resources and created an inherently unstable financi environment. Integration is indeed the route to prosperity, but it needs coordination t ensure efficiency.

In China, the undervaluation of the yuan, low interest rates, and savings-inducing soci policies reduced the cost of entry into manufacturing and created an overwhelming incentiv for Chinese businessmen to focus on exports rather than domestic consumers. In the Unite States, the overpricing of bank assets encouraged excessive risk taking, all because of th unspoken "too-big-to-fail" doctrine, with which the government implicitly guaranteed to ba out banks if they fell into trouble. This in turn left the U.S. economy dangerously depende on a continued credit-fueled expansion in household spending. And in the euro zone, similarly overprotected banking system operating under a one-size-fits-all monetary polic severely mispriced the value of government debt to stoke a credit boom that disguised th region's internal imbalances. To a large extent, these policy distortions can be traced to th twin trends that I've loosely grouped into the two parts of this book: the rise of China as world economic force, and the emergence of a powerful, underregulated, and globalize 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 Chin and other developing countries manufactured stuff and the rest of the developed worl bought it, cannot last. As they gradually reduce their overinflated debt by selling assets in multiyear "deleveraging" process, U.S. and European societies will inevitably face continued slowdown in spending. These advanced economies' consumers are not the pot o gold they were for developing countries' producers and will themselves depend on exports t spur growth. To get the world back to equilibrium, then, policy incentives must change s 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 outcom could be devastating: trade conflicts, social upheaval, even revolutions and wars. In an era i which peaceful democracy appears to be ascendant, and where open trading systems a protected by the World Trade Organization, such conflicts might seem like distant prospect 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. Th only way forward lies in multilateral agreements reached through forums such as the Grou of 20 developed and developing nations and the International Monetary Fund. Yet fo national governments to engage with one another in this way, they too need to be proper incentivized. They will seek to change the status quo only if they are under effective politic pressure do so—if ordinary people like you and me demand it.

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

In movements as disparate as Occupy Wall Street, the U.S. Tea Party, and the Arab Sprin we find evidence of people seeking to force political change for what they see as the bette And that should be encouraging. But for most of them, the focus is on attacking existi institutions rather than building better new ones. Equally important, few of these proteste are focused on what must happen at the international level. Our societies need to take th next step and do so in concert with one another. It's an enormous challenge, but if we don find a way to collectively reform our broken global financial system, the next decade loo bleak.

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

PART ONE

The Rise of China

1

Origins of Dysfunction: How We Got Here

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

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

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

Gold: Stabilizer or Straitjacket?