pcus_6p_all.qxp 6/17/08 3:31 PM Page 9

1

The End of the World

There is nothing quite like the potential for the world economy's coming to an end to focus the mind and shake up a quiet summer. It was the morning of August 10, 2007, and I was chugging away on an exercise bike at the Westmoor Club on Nantucket, a vacation island off the coast of Massachusetts. Improbably piped overhead was Paul Simon singing "Slip Slidin' Away." On the wall, a soundless flat-screen television showed a gaggle of high-cheeked Victoria's Secret underwear models strangely giggling as they "opened" the New York Stock Exchange. The day before, the Dow Jones Industrial Average had crashed a whopping 387 points, nearly 3 percent. The previous night the Asian markets had plummeted, and by morning European markets were sinking by an even greater magnitude. The excited commentators on CNBC, the cable business channel, had reached a state of apoplexy.

The industrialized world was facing a full-fledged liquidity crisis, the Great Credit Crisis of 2007–2008. In a flash, the world's banks and other financial institutions had stopped making loans. Across the

pcus_6p_all.qxp 6/17/08 3:31 PM Page 10

globe, financial deals screeched to a halt. In the United States, potential home buyers couldn't close on their purchases. The global financial system was slip sliding away. It was as if the body's blood had stopped pumping, and the patient, who had seemed healthy only a few days earlier, was slipping into a coma.

Financial market crises are not new to me. As a macroeconomic adviser to many of the big hedge funds and to the proprietary trading desks of some of the world's largest financial institutions, I remember vividly the tense, through-the-night telephone calls during the 1987 stock market crash.

Even the self-assured billionaire financier George Soros had, I recall, a slight tremor in his voice as we both realized that the bottom might be falling out of the world financial system. A decade later, in the fall of 1998, New York Federal Reserve president Bill McDonough nervously explained to a small audience (including me) that the collapse and subsequent market rescue of the trading firm Long-Term Capital Management had brought the world economy closer to the edge than anyone had realized.

As I sat on that exercise bike, leafing through some paperwork that had just been sent from my Washington, D.C., office, I focused on Paul Simon as he sang, "You know the nearer your destination, the more you're slip slidin' away." One of the papers offered a jarring quote. U.S. Treasury secretary Hank Paulson had recently declared: "This is far and away the strongest global economy I've seen in my business lifetime." Yet just that morning *New York Times* columnist Paul Krugman had suggested that the current credit crisis could cause a nightmare "chain reaction of debt defaults." Even worse, he said, policymakers were powerless to respond.

None of this makes sense, I thought. The markets had become hysterical over losses in the so-called subprime market, the relatively small market of mortgages and mortgage-related financial instruments tied to borrowers with no credit histories or abysmal ones. But why a near-global stock market meltdown and a collapse of lending

pcus_6p_all.qxp 6/17/08 3:31 PM Page 11

simply because of some mortgage foreclosures? After all, the problem loans amounted to, at worst, $200 billion in exposure in a global market worth hundreds of trillions.

True, the global economy was in the process of de-leveraging—gradually reducing risk while a housing bubble deflated—but the markets had known that for months. The situation was perplexing. Why would the stock of the world's largest blue-chip companies, which can easily finance their own expansion internally without bank loans, be hit so hard initially by the subprime foreclosures? All of this was a development that should have represented a mere sideshow in the overall scheme of things.

Without a doubt, this would be an interesting day. Already the markets had been spooked earlier in the week when a spokesman for the French bank fund BNP Paribas announced confidently that it had no subprime exposure, then soon thereafter was forced to admit to an uncertain amount of unpriceable mortgages. This mysterious admission pounded both European and U.S. stock markets. It had raised the question: Why didn't the stock of BNP alone take the hit—why the massive losses throughout the industrialized world markets?

Within days the crisis had spread to the commercial paper market, long considered one of the safest bases of investment for money market mutual funds. That meant that middle America was now in trouble. Suddenly, the one market considered the safest, most liquid (non-government-related) investment in the world became suspect. The very foundation of the financial system faced a crisis of confidence. The lifeblood of the global system was suddenly at risk as investors poured their funds into the one short-term investment deemed trustworthy—three-month U.S. Treasury bills. Why is that dangerous? It means that the financial market's liquidity is drying up. When panicked in a similar way during the Great Depression, investors and savers stuffed their money into mattresses. Big corporations had parked their cash reserves in the commercial paper market.

Throughout that Friday in August, the craziness continued. The

pcus_6p_all.qxp 6/17/08 3:31 PM Page 12

Federal Reserve responded by injecting $19 billion into the banking system to keep it afloat and allowed short-term interest rates to float down. This followed the previous day's Fed injection of $24 billion. A fearful European Central Bank injected a whopping 240 billion euros during the first stage of the crisis, believing the European banks were at serious risk. Yet by Tuesday of the following week, despite these infusions of emergency cash, the Dow continued to plummet—first by 207 points, then 167 the next day, then by 280 less than a week later. On Friday, August 17, a spooked Japanese stock market dropped by 874 points, more than 5 percent. Most world markets seemed in a state of free fall. Bond markets were in turmoil as money, distrustful of the private sector, poured further into Treasury bills.

Nobody trusted anybody, so suddenly nobody lent to anybody. The world's credit markets seized up as nobody was sure of their contingent liabilities. That's dangerous because if the private credit markets stop functioning, the entire economy is at risk—people lose jobs, their pensions dissolve, the net worth of average families immediately collapses as the price of their homes plummets below the price of their mortgage. Already the interest rate on consumer loans—automobiles, credit cards, and everything else—was soaring, meaning sooner or later the economy would take a hit.

As I began to reflect on this situation, I realized that, in essence, what really had happened was that American financial institutions had previously placed a large part of their bad subprime loans—their toxic waste—into separate holding facilities, divided the total sum into many smaller portions, and sold these pieces to financial institutions throughout Europe and Asia. Soon the toxic waste was sprinkled throughout the entire industrialized world's financial system, but nobody knew where. Now there was a reason for the rest of the world to hate America.

It is important to remember that the issue here was not the size of the subprime mess; the financial markets could figure that out. The issue was where the toxic waste was located. Who had the cancer and

pcus_6p_all.qxp 6/17/08 3:31 PM Page 13

who was healthy? Ultimately, the issue was information, or the lack of it. And soon a skeptical global financial market would look beyond the subprime mortgage problem and begin to question the credibility of one of the main arteries of the global credit system, the asset-backed securities market.

The following Friday, the Federal Reserve took further action, cutting its discount rate while making available generous loans to the banking system. The goal: to place an emergency ring of safety around the U.S. banking sector based on the belief that if the banks collapsed, so would the U.S. economy. Small businesses would first feel the hit, but soon the entire real economy and the base of American employment would take a real hit. The Fed, still uncertain about which financial institutions held the most toxic waste, needed to stabilize the situation in order to buy time.

By the end of that week, I reflected further on the unexpected turn of events. A relatively minor development had mushroomed into something more, causing the U.S. stock market's value to decline by nearly 10 percent (before eventually recovering after the Federal Reserve cut interest rates). That amounts to a sudden, instant, nearly $2 trillion loss equal to nearly one-sixth the size of U.S. GDP (gross domestic product) .

To add to this bizarre climate, in the middle of the crisis Ben Stein, the comedic actor (who is also an economist), wrote a much-talked-about article in the *New York Times* arguing that for most of the world the subprime exposure is so minuscule, the global reaction made no sense. "How are the risks in Thailand or Brazil or Indonesia intrinsically related to problems in a housing tract in Las Vegas? . . . Why should a mortgage company in Long Island have anything to do with them?" the actor/economist asked.

Part of the answer is that we live in an era of globalization where financial markets have been internationalized through an intricate web of financial engineering called securitization, a subject I will discuss in the next chapter. As Eric Jacobson of the Chicago research firm

pcus_6p_all.qxp 6/17/08 3:31 PM Page 14

Morningstar put it, "There are so many interconnections today between different parts of the market that otherwise seem so disparate." But globalization fails to explain why, seemingly overnight, the financial markets appeared to split from reality, and what the ensuing chaos means for our future.

In the weeks after the outbreak of the crisis, I began to ponder what had happened. How could financial markets reflect a robust economy one moment (the best the U.S. Treasury secretary has experienced in his lifetime) before turning to panic the next? How could apparent calm turn to a genuine threat to the entire economic system virtually overnight?

The best metaphor I can summon is that global financial markets are a bit like a rich, generous, but occasionally deeply paranoid great-uncle. Normally, this benevolent great-uncle sprinkles money calmly and wisely throughout the family, taking a careful reading of risk and the potential investment reward relating to each family member's scenario. But, every so often, a deep, sudden feeling of paranoia overtakes him. Suddenly wary of the landscape, a panicked great-uncle cuts off the spigot of money. What precipitates the sudden paranoia? Nothing more and nothing less than the lack of clear, unambiguous, and reliable information about what is happening. The great-uncle thinks his relatives are not telling him everything he needs to know; they are holding back on him.

During the Great Credit Crisis of 2007–2008, the benevolent great-uncle panicked, not because of the subprime mortgage default, or a U.S. housing bubble that was spreading beyond its shores. The world's financial markets were fully aware of these developments. The panic unfolded precisely because suddenly nobody could say which financial institutions held the subprime toxic waste, and at what price. The situation was exacerbated by the sudden complexity of the financial system as a result of securitization, which resulted in a lack of transparency. When the benevolent great-uncle becomes paranoid as a result of poor transparency, bad things happen. Panic sets in. In this case, the great-uncle suddenly began to doubt the value of the financial

pcus_6p_all.qxp 6/17/08 3:31 PM Page 15

markets' complex new debt investment instruments. For these "paper" securities, the only measure of risk and value came from the credit rating agencies, which measured risk based merely on sophisticated mathematical models.

In some cases, lack of transparency can lead to euphoria that fuels financial bubbles because of lack of factual information. In this case, however, lack of reliable information caused global lending to screech dangerously to a halt. But there is a broader point of this discussion. The dramatic rise in financial panics is the direct result of the last quarter-century's economic globalization of the world economy. Globalization led to greater worldwide wealth, which created a volatile ocean of capital now roaming the world in search of investment opportunities. This ocean of capital has become our policymakers' great challenge.

Many months before this great crisis, I began pulling together my thoughts for this book. The subject would be the imperfect good we call globalization. My thesis: that the integration of the world's financial markets during the past quarter-century led to a golden age of wealth creation and poverty reduction never before seen in the history of mankind. That's the good news. With the introduction of China and India to the global capitalist system, the industrialized world during this remarkable period accomplished the near miraculous. In little more than two decades, the global free market experienced an unprecedented doubling of its labor force—from 2.7 billion to 6 billion, with no revolution, no serious riots in the streets, not even a threatened, across-the-board shutdown of the trading system.

This phenomenal success stemmed from a global paradigm shift, accelerated by the collapse of the Berlin Wall, which led to the broad-based belief that economic success results, not from government or even from the large corporate sector, but from the ongoing innovations by a risk-taking global entrepreneurial class. It is this class that allows economies to continually reinvent themselves. Most important, this innovation and economic reinvention is fueled by a modernized, global financial system of capital allocation, risk assessment, and cross-border investment within a climate of free trade.

pcus_6p_all.qxp 6/17/08 3:31 PM Page 16

The result, financial crises notwithstanding, has been an unprecedented wave of prosperity—forty million new jobs in the United States alone, under both Republican and Democratic presidents, which is more than was created by the rest of the industrialized world combined.

During this quarter-century, the Dow Jones Industrial Average climbed from 800 to over 12,000. To match that stock market success in percentage terms over the next twenty-five years, the Dow would have to exceed 170,000. In 1982, at the beginning of this period of global financial market integration, the net worth of U.S. households equaled $11 trillion; today it exceeds $56 trillion, according to the Federal Reserve. Even when adjusted for inflation, this represents an amazing feat of wealth creation.

From 1980 to the present, the value of all global financial assets has jumped from $12 trillion to $140 trillion, a 1,166 percent increase. Global financial assets have jumped from roughly 100 percent of worldwide GDP in 1980 to 325 percent today.

The bad news is that today's spectacular global economy is both unstable and unsettling. As jobs and investment move around the world, people lose incomes and pensions. And as these enormous shifts occur, the economic benefits of the system are often unfairly distributed. As *Fortune*'s Nina Easton wrote, "There's not a lot of security in a fast-paced global economy where workers get ahead by chasing opportunities (not obediently following official rules), by constantly reinventing their careers (not relying on seniority), and by self-investing their savings (not counting on company pensions)."

Despite enormous wealth creation, this new era of free-flowing global capital and abundance has also been accompanied by an era of financial crises. Charles Kindleberger, in his book *Manias, Panics, and Crashes*, catalogs a full history of financial crises. Yet, according to the World Bank, the last quarter-century of prosperity has been the high point for systemic banking crises, far more, for instance, than during the preglobalization quarter-century. Yet at the same time, the world

pcus_6p_all.qxp 6/17/08 3:31 PM Page 17

ironically has benefited from reduced volatility in inflation and jobless rates in recent decades.

How to respond in the face of these opposing economic factors is the most critical issue facing worldwide policymakers today. If they overreact to the uncertainty of today's liquidity and credit situations, they risk a financial and economic reversal that will affect us all. Ironically, the best intentions can lead to higher interest rates, greater joblessness, far less robust equity markets, less charitable giving, and a devastatingly bitter rise in the levels of global poverty. However, this does not have to happen if policymakers recognize the fragility of the capital markets and adopt new, carefully targeted strategic approaches to this brave new world.

Make no mistake, financial instability notwithstanding, the last quarter-century of liberated global financial markets and free trade has produced the proverbial goose that lays the golden eggs, in terms of political freedom, wealth creation, and poverty reduction. In 1975, for example, only 25 percent of the 147 countries of the world were considered democracies; today, after a quarter-century of globalized markets, that figure is 58 percent. As Kofi Annan, former secretary general of the United Nations, has said: "The main losers in today's very unequal world are not those who are too much exposed to globalization. They are those who have been left out."

Gary Hufbauer of the nonpartisan Peterson Institute for International Economics argues that the United States is more than "one trillion dollars richer each year because of globalized trade." That amounts to nearly 10 percent of GDP, or an incredible $10,000 per household. In their book *World Capital Markets: Challenge to the G-10*, Hufbauer and Canadian economist Wendy Dobson assert that the economic gains from liberalized capital flows now equal or exceed those from liberalized trade.

Robert Bartley, the late editor of the editorial page of the *Wall Street Journal*, wrote a book about the Reagan economy called *The Seven Fat Years* (November 1982–July 1990). If someone writes a sequel,

pcus_6p_all.qxp 6/17/08 3:31 PM Page 18

it should be called *The Twenty-five Fat Years*, including the amazing time of peace and prosperity under President Bill Clinton, who was a champion of the new global financial system.

This quarter-century also represents the most successful period of mass poverty reduction in the history of mankind. In 2006, I commissioned an article for my magazine, *The International Economy*, to try to measure the globalized financial market's performance at poverty reduction since 1980. The writer, I reasoned, should come from neither any government agency nor any think tank dependent on a relationship with the World Bank; nor any private poverty agency, many of which were almost psychotically distrustful of markets. Nor should the writer be on an ideological mission on the right. Adam Posen of the Peterson Institute, an executive editor of our magazine, recommended Surjit Bhalla, a former World Bank official and Goldman Sachs partner who now is a private investor. Known for highly independent thinking and research, Bhalla accepted the task.

He concluded that we have just witnessed something historic. The last quarter-century has represented a golden age of poverty reduction, all occurring during the shift toward globalized financial markets. With poverty defined by the traditional dollar-a-day measure (the standard used by the international agencies), about a billion people have been moved out of poverty since 1980. Put another way, during the period 1950–1980, when the World Bank and other international agencies, flush with money, were in their heyday, there was actually a significant *increase* in global poverty. And this was the period of big government spending, including major loans and grants to the developing world. These well-intentioned efforts suffered because without efficient and honest institutions in recipient countries, the results of government-to-government transfers will always disappoint.

The golden age of poverty reduction came in the post-1980 period of globalized markets, with the level of poverty declining an astonishing 20 percent. Large turnarounds, not surprisingly, appeared in India and China after both embraced entrepreneurial capitalism and lowered

pcus_6p_all.qxp 6/17/08 3:31 PM Page 19

tariffs. But even Latin America and Africa, the big holdouts, began to see poverty decline starting in the year 2000.

To be sure, the world still contains much pain and suffering. Greater public and private efforts are needed to confront, in particular, the rampant AIDS crisis that exerts a choke hold on the African continent. One dollar per day may also be too low a measure for the poverty line, even though it remains the industry standard based on a 1994 dollar baseline valuation. But in the end, simply looking at bottom-line results, it appears that entrepreneurial capitalism within a financially integrated global system is the only model capable of delivering full-throated, out-and-out poverty reduction. Witness the billion people who have been lifted out of poverty in the past quarter-century.

To reiterate, none of this is to suggest that efforts to alleviate health and medical problems are not essential. High-profile philanthropists such as Bill and Melinda Gates deserve enormous credit for their efforts. Rock star Bono performs an important and commendable service by snapping at the heels of the World Bank and the international drug companies to offer support. But these efforts are a sideshow relative to the power inherent in market capitalism. Bono himself recognizes this point. In March 2007 he told the *New York Times*, "One of the things that I have learned in Africa is the crucial role that commerce will play in taking its people out of extreme poverty."

Although flawed, sometimes disappointing, and often unpredictable, globalization has been a highly impressive wealth-creating machine. But, after twenty-five years of dramatic economic performance, we still do not know all the implications—good and bad—of globalization. We do know that despite several decades of a rapidly globalizing system, government policymakers and politicians for the most part understand little about the unique nature of today's economy.

For many, the economy remains a static entity to be fought over by competing political forces in an emerging era of class warfare. Actually,

pcus_6p_all.qxp 6/17/08 3:31 PM Page 20

the global economy is more like a highly dynamic, living organism. *Newsweek*'s Robert Samuelson notes a remarkable statistic: "Every three months, seven to eight million U.S. jobs disappear and roughly an equal or greater number are created."

Most of all, this new global economy is vastly different from the old system in which corporations and their elite handlers worked a global system of controls to maintain relative stability. Now, just the opposite is the case. More than ever before, large corporations are forever threatened with obsolescence by a risk-taking, extraordinarily venturesome entrepreneurial class of individuals, who themselves constantly face the possibility of failure. Just as IBM was once threatened by Microsoft, now Microsoft is threatened by upstart Internet-enabled companies, such as Google or the open-source operating system Linux.

The situation may be further complicated by the reality that we are entering a new interactive age where a mass collaboration via the Internet is transforming the way businesses create and add value. This is a populist-style process of international business reform in which a bottom-up dynamic may gradually be taking over the global economy. In a later chapter, I will discuss what this means for China, where the government now has implemented a strange new policy to try to police Internet content. Ultimately, however, we have no other choice in this increasingly volatile world but to embrace the globalized market and to subtly direct it to a greater good with the least number of negative, unintended consequences. As President Bill Clinton said in his 2000 State of the Union address, "There's no turning back. And our open, creative society stands to benefit more than any other."

As a result of globalization's immense wealth creation, the world has been awash in money, and much of it the past few decades has sought haven in the United States. Dino Kos, the former head of the New York Federal Reserve's foreign exchange desk, watched tides of large capital come in every day. Here is how he summed up the situation before the outbreak of the credit crisis: There was "an ocean of liquidity

pcus_6p_all.qxp 6/17/08 3:31 PM Page 21

out there. The productivity revolution had gone global. The entire world had gotten a lot richer a lot faster than any of us realized."

Indeed, there was for a while a shortage of global investment opportunities with too much of the world's capital dependent on investment in U.S. and other industrialized world financial assets. Since 1995, for example, $6.5 trillion in net foreign capital has flowed into the United States, which is $1.7 trillion more than the trade deficit for this period. The international system is out of balance, which is why Federal Reserve chairman Ben Bernanke has argued for a long-term policy of global rebalancing. The United States, he argues, needs to undergo "a shifting of resources out of sectors producing non-traded goods and services to those producing tradables." Translation: America needs to reduce its budget deficits and dependence on foreign oil while expanding its exports of goods and services. Other countries need to stimulate domestic demand so they can purchase more imports and rely less on exports. This shift, however, will take time and, in the meantime, the U.S. economy will depend on foreign investment.

Furthermore, some in the U.S. political community have taken the posture that foreign investment, like some mad monster, threatens the core of America's existence. The situation is not that simple. In reality the threat to that existence, in the short run, is the widespread perception that America no longer welcomes foreign capital. For decades, global investors have regarded the U.S. economy as a safe haven for international capital. Studies show that U.S. companies financed by direct foreign investment issue big paychecks, 32 percent above the average for the rest of the private sector, according the the *Wall Street Journal*. America has been a highly attractive investment target for the global financial system. Only a fool would do anything to alter that perception until the global system is rebalanced, with the United States putting its fiscal house in order and other parts of the world restructuring economically to become less dependent on exports. But for now, populist political rhetoric against foreign capital has begun to

pcus_6p_all.qxp 6/17/08 3:31 PM Page 22

make global financial market traders and investors nervous. They ask: Do the American economic populists understand the extent to which they are playing with fire?

In the end, the future of the globalized world economy rests on these fundamental questions: What is the definition of liquidity? And why does liquidity (and its cousin, credit availability) one minute seem to be in overwhelming abundance and the next minute appear to have completely vanished? To what extent does liquidity reflect true growing value in an expanding global economy?

Perhaps the best metaphor to illustrate liquidity is the oil in an automobile engine. If the oil just collects in the bottom of the engine pan, even if there is plenty of oil, the engine seizes up. The oil needs to move freely throughout the engine.

Today's central bankers struggle with the issue of liquidity. At times, in a financial panic, liquidity (oil) can suddenly move quickly to one location (down to the engine pan), which in today's economy means purchasing only short-term government debt. When that happens, credit contracts and the entire economic and financial system is at risk. The engine's pistons could soon stop pumping.

During the Asian and Russian financial crises in 1997–1998, for instance, global liquidity instantly dried up. After a period of abundant liquidity, credit was nowhere to be found. The Great Credit Crisis of 2007–2008 was accompanied by a similar development. The situation was frightening in both cases, but why did the liquidity dry up so quickly? And, indeed, what drives this thing we call liquidity?

When it is pared down to its essence, it may be that liquidity, when all is said and done, is not much more than confidence. Federal Reserve governor Kevin Warsh makes this case, arguing: "Powerful liquidity in the U.S. capital markets is evidenced when the economic outcomes are believed to be benign. When the [highly negative] outcomes are either highly improbable or, at the very least, subject to reasonably precise measurement, the conditions are ripe for liquidity to be plentiful." Alan Greenspan as Federal Reserve chairman also argued that liquidity is just another word for confidence. In a later chap-

pcus_6p_all.qxp 6/17/08 3:31 PM Page 23

ter, I'll discuss how the former chairman and I have had a number of discussions about how the job of central banking, because of this need to bolster confidence, has become an elaborate form of "theater," with the financial markets acting as the audience. Liquidity, therefore, to a significant degree depends on the market's confidence that policymakers in the near future won't make a series of huge blunders. During the subprime crisis, the world's central banks from the start flooded the world with injections of available "liquidity." Yet the credit crisis continued because of the global market's lack of confidence in the financial architecture, including the financial system's ability to truly measure risk.

In essence, the survival of the world financial system depends on an elaborate global game of confidence. The size of the financial markets, relative to the governments, has become so monstrously huge, there is no other means of maintaining stability than to establish a psychology of confidence. The governments themselves cannot by edict restore order. They can only project to the markets a sense that they know what they're doing.

Consider the example of UBS, Switzerland's largest bank and one of the largest financial institutions in the world. During the 2007–2008 subprime crisis, the Swiss central bankers discovered, to their utter dismay, that the total financial exposure of just one of their banks, UBS, amounted to more than 2 trillion Swiss francs, according to the Swiss National Bank. Yet Switzerland's entire GDP is only 475 billion Swiss francs. In the event of a panic and serious capital outflows, the liabilities of one bank alone are more than four times the size of the entire economy. Translation: The Swiss government in a time of crisis could not afford to bail out its financial system even if officials wanted to. Policymakers in the rest of the industrialized world find themselves in a similar situation, particularly when considering the fact that financial institutions engage in a considerable amount of leveraging (borrowing against current investment assets to make new investments).

For today's policymakers, financial market panics represent the

pcus_6p_all.qxp 6/17/08 3:31 PM Page 24

ultimate enigma. Whenever the psychology of human paranoia comes into play, uncertainty rules the day. Experts still debate the factor, or set of factors, that led to the 1987 crash of the U.S. stock market, a market correction that in today's terms would amount to a one-day 3,500-point drop in the Dow Jones Industrial Average. At first, conventional theory blamed the crash simply on the role of computerized portfolio insurance in worsening an initial market slide. Yet what is now clear is that a series of seemingly benign developments, when piled together, seriously undermined confidence, which led to the sudden breakdown of the international financial order.

Market participants came to believe that policymakers were disrupting the global system, a development that led to broad investor panic and a loss of confidence. In the lead-up to this period, policymakers made some seemingly minor blunders that, as they snowballed, turned out to have devastating consequences as millions of market participants lost confidence in the future. The comparison to today is not without merit.

For example, in the fall of 1987 a public dispute emerged between U.S. Treasury secretary James Baker and his German counterpart, Gerhard Stoltenberg, over the dollar and interest rates. This created the perception of the loss of international financial order and certainty. The Reagan administration had also levied trade sanctions against Japan, creating uncertainty about the future of free trade. A week before the crash, the House Ways and Means Committee announced plans to raise taxes on debt associated with corporate takeovers, which many market participants interpreted as a highly bearish development for financial markets. Around that time, a U.S. House of Representatives subcommittee passed the amendment of 1988 Democratic presidential candidate Richard Gephardt (an adviser to Hillary Clinton in the 2008 presidential election) that would slap nasty sanctions on countries running "excessive and unwarranted" trade surpluses against the United States. All of these developments left markets fearful that global capital flows were at risk of disruption.

The bottom line is that in 1987 a deadly combination of seemingly

pcus_6p_all.qxp 6/17/08 3:31 PM Page 25

minor technical missteps and less-than-careful political posturing nearly sank world stock markets—and the global economy to boot. In the world of policy and markets, people matter. Financial markets were jittery and suddenly perceived an unwillingness of the big powers to cooperate. Almost overnight, stock price declines fed on themselves, creating a financial horror show of historic proportions. True, the stock market bounced back, helped by the sense among financial participants that the G7 industrialized-nation policymakers (from France, Germany, Japan, the United States, Canada, Italy, and the United Kingdom) coordinated their actions when the crisis erupted. Given today's key players—which include China, India, Russia, and the other oil-producing, excess-savings economies—such coordination and single-mindedness are far less likely to happen in the event of a major market meltdown.

What is clear is that financial instability is here to stay. In a study of the history of financial turbulence, noted economists Barry Eichengreen of the University of California at Berkeley and Michael Bordo of Rutgers make the case that financial crises today "are twice as prevalent" as they were a century ago.

The Great Credit Crisis of 2007–2008 is the ultimate case in point. But could today's new independent ocean of liquidity further dry up, causing the global wealth machine to shut down? Unfortunately, the picture is not reassuring. That's because the rest of the world's politicians are likely to follow in America's missteps, especially on the issues of protectionism and clumsy financial market regulatory tinkering.

There are a number of key unknowns, but one of the most vexing is political uncertainty. Globalization's opponents include both Republicans and Democrats in the U.S. Congress. Backed by powerful interest groups worried about the uncertainties of international competition, they already are labeling the process "the world's race to the bottom." Early on in the 2008 U.S. presidential race, both Democrats (led by former senator John Edwards) and Republicans (led by former governor Mike Huckabee) uttered strikingly similar antiglobalization

pcus_6p_all.qxp 6/17/08 3:31 PM Page 26

themes, with most of the other candidates refusing to defend the system. That is because globalization, while creating enormous wealth, has produced widespread anxiety. Job outsourcing, once limited to relatively unskilled labor, now poses the appearance of a real threat to middle-class jobs. The truth is that America so far has been a massive net "insourcer," not an outsourcer, of jobs. Foreigners invest a half trillion dollars more in the United States than Americans invest abroad, which is one reason the United States creates a net two million new jobs every year.

A study by economists Gordon Hanson and Robert Feenstra argues that outsourcing has actually raised the real wages of unskilled workers. Economists William Dickens and Stephen Rose argue that the outsourcing criticism is exaggerated: "Modern market economies regularly destroy and create tens of millions of jobs just from their own internal dynamics. Trade plays a very small role in this job churning. The largest source by far of job loss remains *domestic* competition." McKinsey's Martin Baily and Harvard's Robert Lawrence agree, arguing that 90 percent of jobs lost in manufacturing are the result of domestic forces, mostly technological advancements that force companies to eliminate workers.

Still, the global system is changing, with a potential economic shift in coming years from manufacturing to services. China, India, and the other Asian economies could soon reach a state of huge excess capacity in manufacturing. To maintain their economies, these nations will turn to services, the mainstay of the U.S. and U.K. economies (in the United States, more than 80 percent of jobs are in the services industry). Even if America remains a huge net-jobs insourcer, the anxiety felt by those in the service sector will remain and intensify. Accountants, lawyers, radiologists, and others already fear that their livelihoods could be at risk, given the new breed of competitors from abroad. Even though some experts feel that the fear regarding service jobs is somewhat overblown, the fears themselves are a threat.

Economists such as Columbia University's Jagdish Bhagwati, for example, counter that in the services industry, "proximity of personnel

pcus_6p_all.qxp 6/17/08 3:31 PM Page 27

is often indispensable" as many services jobs "cannot be done long distance." I agree that the threat is exaggerated, but the *feelings* of anxiety are very real, and they are likely to trigger a very real U.S. political counterresponse that could prove highly unsettling to global markets. Indeed, in America, the cauldron of populist discontent against the so-called big corporate interests is boiling faster by the day.

The worrisome question is whether politicians realize how little they can control this global system with legislative or regulatory tinkering without producing unintended negative consequences. This situation evokes memories of what the British government did in the 1960s when they tinkered with their financial system by prohibiting people from taking money out of the country. What was, in effect, an elaborate, seemingly benign policy experiment intended to keep the currency from weakening (despite running questionable expansionary policies during a period of rising inflation) proved disastrous. The market tinkering backfired, nearly destroying the savings of the British middle class. That is why policymakers, with today's raging ocean of capital, should approach policy tinkering with a strong dose of humility. The global markets can be an angry, unpredictable beast, easily provoked.

Today we are living in strange new times where, with the exception of nations that export commodities (Russia and the other oil producers), the global economy is becoming increasingly beyond the positive control of the governments. Even China cannot easily be controlled by its central government, which errs in trying to micromanage when the market could better allocate resources.

In this new world, governments are struggling for relevance. Not that long ago, the picture was much clearer. For example, government institutions such as the World Bank, the International Monetary Fund, and the Paris Club of Third World debtors were instrumental in helping to coordinate capital flows. With the emerging markets now paying off debt and the world loaded with cash, these governmental institutions are scrambling to maintain a vital international role.

pcus_6p_all.qxp 6/17/08 3:31 PM Page 28

They haven't a moment to lose. The Chinese and Indian governments are already moving throughout the emerging markets handing out cheap (subsidized) loans tied to agreements involving the exchange of commodities, led by oil. But these actions have already raised the levels of tension and resentment throughout the global economy. A perception is growing that while China benefits from the global system of trade in goods and commodities, it does little to enhance the stability of that system and, at times, undermines its stability.

Essentially, the Chinese and others are underbidding the World Bank—and, unlike the World Bank, their loans involve no environmental or human rights standards. For evidence that China, India, and others are marginalizing the World Bank, IMF, and other agencies, consider what happened in Washington the weekend of April 14, 2007. The industrialized nations held an important IMF–World Bank meeting of finance ministers and central bankers. The Chinese didn't bother to show up. At the next meeting in early October 2007, the Chinese sent a relatively powerless central bank deputy instead of the most senior officials. The reason cited for their absence: They were preoccupied with more pressing domestic concerns.

In chapter 4, I will show the potentially unsettling nature of China's relationship with the world in coming years. Greg Mastel, the former chief trade adviser to the U.S. Senate Finance Committee (2000–2003), suggests that there are many examples of future turmoil, including coming disagreements over environmental policy. Argues Mastel: "If China were to exempt its steel or chemical industry from greenhouse gas emission controls or pay them large subsidies, competing industries in the United States and Europe would be at a devastating disadvantage." This is because the bylaws of the World Trade Organization (WTO) make the United States and Europe relatively powerless to respond with effective tariffs on Chinese imported products. The WTO allows trade restrictions only for "the conservation of exhaustible natural resources." The rules regarding trade actions in response to national environmental policies are murky at best. Mastel

pcus_6p_all.qxp 6/17/08 3:31 PM Page 29

foresees a situation in which the United States and Europe could see core industries unfairly hollowed out, with little they can do legally in response.

Yet in this globalized world, where capital flows have made up for America's budget and current account imbalances, one assumption has remained constant—that global capital must continue to flow freely. If these capital flows cease, whether because of government intervention, heavy-handed partisan politics, or the complete breakdown of the international order as a spin-off of a trade war with China, the potential for a negative global herd effect is enormous. Global money managers talk to each other. In a new world of dominant global markets ruled by sentiment and psychology, just the whiff of a protectionist economy or an economic turf war between countries will have disastrous consequences.

We may not like the interdependent nature of this system, but it is the reality of the day. And in this new interconnected world, pessimism can be highly contagious. Market theorists are already speculating that environmental forces and the forces behind free trade are on a collision course. Should it become apparent that America is going the way of trade protectionism, there is a real risk that confidence in the global entrepreneurial model of free-flowing capital could dry up overnight. The danger to the global economy is enormous because today's protectionist tweaking can easily become tomorrow's trade and commodity war—resulting in a new, frightening era of even scarcer liquidity.

Over the last quarter-century, America has championed the bipartisan concept that open markets, a turbocharged entrepreneurial capitalism, and freely flowing international capital markets represent a magic formula for economic success. Wealth stems from imagination, discovery, and innovation. In recent decades, America has proved to be a veritable hotbed for technological breakthroughs—from the iPod to Google to YouTube, although the situation is now changing.

Geopolitical complications in the Middle East, the collapse of

pcus_6p_all.qxp 6/17/08 3:31 PM Page 30

confidence in the credit markets and our financial architecture, and global uncertainty in general have already cast a gray cloud over the innovation process in the United States. It is not surprising that American corporate CEOs, even before the subprime-related crisis, were beginning to pull back, preferring stock buy-backs and mergers and acquisitions over the risk of investment in new ventures. A dispirited U.S. Congress, with record low approval numbers, was already losing confidence in America's global economic future. That governing body is clearly mulling over the possibility of placing the economy in hibernation in an attempt to achieve some false sense of economic security by offsetting risk.

The Law of Unintended Consequences is about to take over because policymakers worldwide still believe they can control the global economy. We are about to discover the implications of this misconception as millions of market decision makers—the stewards of this new ocean of capital—weigh their options.

Recently someone asked me to name specific examples of how the new global economy could further unravel. There are hundreds of possibilities. After all, who would have predicted the global devastation as a result of the U.S. subprime mortgage collapse? Imagine, I said, that Washington policymakers become even more involved in setting America's accounting standards so there develops a clear division between the United States and the rest of the world to America's disadvantage. This move would isolate the United States in such a way as to further discourage foreign investment.

Or imagine the U.S. Congress setting up investment barriers to foreign ownership of U.S. companies. The rest of the world responds with tax hikes and/or regulatory assaults on U.S.-owned company assets overseas. Think such a nationalistic scenario is far-fetched? In 2005, fifteen Democrats in the U.S. House of Representatives crossed the aisle to support the Central American Free Trade Agreement, or CAFTA. Since then the so-called CAFTA 15 have nearly been run out of the party for their free-trade transgressions.

pcus_6p_all.qxp 6/17/08 3:31 PM Page 31

Imagine a populist political tide rising up to replace the alternative minimum tax in the U.S. tax code with, say, a 70 percent or 80 percent tax on personal income above $2 million. As a result, a significant part of the American entrepreneurial and financial services sector moves offshore, which produces the unintended consequence of severely crunching the U.S. charity sector. Or imagine that the Doha Trade Round collapses for good and the global free-trade consensus vanishes. It is hanging by a thread now. Suddenly, emerging market political leaders tell the world to hell with patents or guaranteed payments on loans on anything considered a "public good" (pharmaceuticals, water treatment facilities, etc.). The United States retaliates by putting up barriers. Global commerce drops like a stone while the world's financial markets melt down.

Imagine that Washington decides to restrict cross-border movement of intellectual property, and foreign graduate students are banned from U.S. universities. Within several years, the United States becomes like Europe—far less innovative.

Imagine some well-intentioned administrative tax or minor regulatory change on the U.S. Treasury market causing a swift decline in the value on T-bills. Then a group of enterprising bond traders in Japan, or, more likely, France, takes advantage of this change in circumstances, driving the U.S. bond market into broad-based chaos and collapse. Or imagine that the United States and Europe band together to heavily regulate energy efficiency. They produce environmental standards in the form of a tax on imported goods from economies producing high carbon emissions, with China being the major culprit. China retaliates with a tariff on the American agricultural and banking sectors, causing a major Wall Street meltdown.

With pension funds pressured to increase yield, imagine a bumbling U.S. congressional effort to reduce risk-taking by financial traders, which over time produces the unintended consequence of a pension fund crisis, not dissimilar to the commercial paper crisis of 2007. Imagine a continuation of the post–Sarbanes-Oxley climate of

pcus_6p_all.qxp 6/17/08 3:31 PM Page 32

caution that slowly eats away at American corporate competitiveness. Think of the unintended consequences of Americans feeling that they are no longer number one. Less competitive, they become peeved. Congress reacts, matters escalate, and the thing most essential to the survival of the new global economy—liquidity—further dries up. Interest rates soar and the cycle of economic terror begins. And for average investors, there is no place to hide.

The global system is becoming more vulnerable with each passing month. Recently, efforts were launched to give the U.S. Congress greater political influence over CFIUS, the Committee on Foreign Investment in the United States, a government agency with the power to void foreign investment in the United States based on national security concerns. CFIUS, which performs a vital public policy function, is aimed at the roughly dozen foreign state-owned investment funds (known as SWFs, or sovereign wealth funds) owned by the commodity-monopoly-dependent states (Saudi Arabia, United Arab Emirates, Dubai, Russia, etc.) that control roughly $2.5 trillion.

But the question is whether these necessary efforts at greater oversight of the state-owned investment funds reach beyond their stated mission of monitoring for national security concerns. The early signs are not encouraging. Already the European Commission is in the process of implementing rules significantly more restrictive than those the U.S. plans. The suspicion is that the European bureaucrats are using this situation as an invitation to increase regulatory control over financial markets in general. One of their goals is to protect domestic firms from the traditionally highly competitive U.S. financial services sector.

Yet the Western political anxiety associated with these state-owned funds cannot be dismissed. After all, China, India, and the oil-producing economies control large amounts of the world's excess savings. In the end, are Americans going to be comfortable allowing, say, a KGB-controlled Russian government or the Chinese government to buy 10 or 15 percent stakes in Microsoft, Google . . . or Boeing, po-

pcus_6p_all.qxp 6/17/08 3:31 PM Page 33

tentially with seats on the boards of directors and access to proprietary information? And if not, how will the Russian, Chinese, and Saudi governments respond given the enormous Western investment in their economies? Where do we draw the line between free enterprise within the global marketplace and strategically oriented decisions by government-controlled investment vehicles with political agendas?

On a recent trip through Europe, I spoke with the head of a major European central bank who told me of his recent visit to Shanghai. The Chinese government, in providing a tour of the city, took him by car on a thirty-five-minute drive outside Shanghai to a small "city" of large, spanking new, completely empty office buildings. The European official responded to his host: "These buildings are spectacular, but they are all empty. Why is that?" The Chinese host responded: "The office buildings won't be empty for long. Soon they will house the employees of our government's new overseas investment agency." Said the European: "I can see the government is redefining the concept of central bank reserves. They're not reserves any longer; they're your government's investment capital ready to go on a global buying spree." The Chinese host's response: "Something like that," which brings up the question: Do the world's industrialized economies have an effective strategy for understanding the nature of these proposed investment flows?

Yet to add to the confusion, most sovereign wealth funds, ironically, so far tend to be interested largely in passive, nonleveraged, long-term investments in Western enterprises. In other words, to date they, thankfully, are likely to be the last to sell in a market downturn. In the next chapter, I will discuss today's roving bands of international investors called hedge funds. It may be that in the event of widespread global economic weakness the following scenario unfolds: The hedge funds short, or bet against, the global economy while the large sovereign wealth funds working side by side with the industrialized world central banks fight to counter the pessimism with major investments in the industrialized world markets. Some small, more independent

pcus_6p_all.qxp 6/17/08 3:31 PM Page 34

sovereign wealth funds, to confuse matters even more, may short the market through private hedge fund investments made through international trading collectives called funds of funds.

What this all adds up to is that the world today appears to be moving away from the model of globalization and unfettered free markets of recent decades toward something more reminiscent of the nineteenth-century model of globalization—a new, more mercantilist era of backroom rivalries, deal-making, and tensions based on ambitious national political agendas and capital shifts controlled by governments. The innocent, well-meaning G7 policy coordination by democratically oriented industrialized nations of recent decades, what little there was, is fading fast. The so-called Anglo-Saxon world of free capital markets is under siege. The upshot is that the potential for disruption in the entire global financial market is growing exponentially.

Not convinced? One of the things contributing to today's soaring oil prices is hoarding by sovereign governments. China, India, and other major consumers are distorting the world market by increasing energy reserves with the expectation of higher prices. As analyst Harald Malmgren notes, "The expectation of rising prices is also reducing the incentive [of the oil producers] to increase production as oil in the ground looks like an asset with rising value." Other global entities currently hoarding oil include military services, farmers, trucking companies, producers of fertilizers and plastics, power plants, and other large-scale users. Note too that if energy prices spike further, the impact on world food prices will be huge, as the costs of fertilizers and farming transportation skyrocket.

Today, the world is undergoing a kind of tectonic change in the area of finance. The United States, once a bastion of trust for its transparency, rule of law, benign political environment, and overall conditions that nurtured increases in economic productivity, is beginning to be viewed with some skepticism around the world. America finds itself in a precarious position at the precise moment that other countries have emulated America's productivity-enhancing practices

pcus_6p_all.qxp 6/17/08 3:31 PM Page 35

and have started to become relatively attractive targets for global investment. As a result, the global center of financial activity has begun to shift away from the reality that placed the United States at the epicenter of all things financial—not unlike the situation the British found themselves in during the period after World War I.

Still not convinced? Recently, a Swiss banker described to me the process by which a Chinese company's initial public offering was financed with the modest help of its Swiss bank. In conducting the transaction, the Chinese took the unusual move of simply bypassing the New York and London financial centers, traditionally the intersection of global financial intermediation, and appealed directly to Dubai financial sources—something that would have been unheard of a decade ago. Because of the uncertainty now surrounding the U.S. financial system, particularly in the wake of the subprime disaster, America is at risk of losing its perceived uniqueness as a trusted repository for global investment.

That is why the world capital markets have become a veritable house of cards. The world is at risk of losing its anchor, its admittedly flawed, yet reliable voice consistently in favor of free trade and open capital markets—the United States. But to truly understand the risks out ahead, it is essential to know how we arrived at our current predicament. In other words, how did globalization come about and what are the terrifying dangers lurking just around the corner?