Prologue

It was not without enormous frustration that I approached writing a book about today's new global economy. After all, what do we make of a world financial system that one minute appears to be performing beautifully, and the next acts as if the world is coming to an end? One minute the cybernetic (computer) revolution has transformed the economy into a veritable global wealth machine, as stock markets around the world soar to new highs. The next moment, markets plummet. People then read newspaper stories suggesting the value of their home may soon be less than their mortgage. They discover that their family's life savings—even their cash left in supposedly ultrasafe money market funds—could soon go poof in the night.

In trying to fully grasp the significance of the new global system, I began by rereading the seminal book on the subject of globalization, Tom Friedman's bestseller *The World Is Flat: A Brief History of the Twenty-first Century*. Friedman compellingly describes globalization *as it is*, with concentration on the global supply chain for goods and services. The stories are mesmerizing—taking the reader from India's

Silicon Valley in Bangalore to villages in northeastern China. Friedman's book describes how digital technology shortened the distances between countries and revolutionized the global supply chain. This permitted people to engage in business with one another across the globe, with each nation bringing its comparative advantage to the table of world commerce. An award-winning columnist for the *New York Times*, Friedman wisely warns that the U.S. economy must adapt to this new and changing environment or retrench economically. The book stands as a historic achievement in introducing a broad audience to the new world of opportunity and challenges beyond national borders.

After rereading *The World Is Flat*, I had lunch one day at the Hay-Adams Hotel in Washington, D.C., just across from the White House, with an old friend, John Despres, who had been Democratic U.S. senator Bill Bradley's longtime foreign policy guru. "John," I said as we were being seated, "I am trying with great frustration to get my arms around globalization. Frankly speaking, from the perspective of the financial markets, the world is *not* flat. Unlike the world that produces goods and services, in the financial world nothing happens in a straight line. Instead, there is a continual series of unforeseen discontinuities—twists and turns of uncertainty that often require millions of market participants to stand conventional wisdom on its head. In the financial world, John, nothing much seems to happen in a straight line."

A pensive man in his sixties who chooses his words carefully, Despres sat there thoughtfully. He stroked his chin, pondering as he gazed off into the distance past Lafayette Park to the front columns of the White House. "So what you're saying," he slowly began, pausing for several more seconds, "is that the world is not flat; the world is curved."

"Yes," I responded, "for the financial markets, the world is curved. We can't see over the horizon. As a result, our sight lines are limited. It is as if we are forced to travel down an endless, dangerously twisting and turning road with abrupt steep valleys and risky mountainous climbs. We can't see ahead. We are always being surprised, and that is why the world has become such a dangerous place."

By way of background, financial markets have always been plagued by uncertain and incomplete information—a lack of transparency. There have always been things that investors and traders didn't and couldn't know. But in the new global economy, this crazy ocean of global liquidity has not only increased the number of unknowns but also rearranged their relationships and relative importance.

There are new players with new perspectives. All of a sudden, a huge pool of funds is competing around the world for investment opportunities. Bankers, businesspeople, and governments in industrialized economies are now competing with entrepreneurs, start-ups, and old state-controlled companies in emerging economies to attract those funds. With new kinds of securitized debt, mezzanine investing, and outrageously complicated financing instruments, it is almost impossible to figure out what is going on at any give time. Investors need new kinds of information to make good decisions. But exactly what kind of information is that? And where do they get it?

Financial markets have always operated on inequalities of information and analysis. You think or know A. I think or know B. But today's policymakers and market traders must depend more than ever on their gut instincts. The playing field is bigger, the stakes are higher, and the system, because of its size and complexity, is unbelievably fragile. It is a house of cards that could come tumbling down for any number of reasons. That won't necessarily happen, but politicians and policymakers need to be careful. They need to start caring about things that never much mattered to them before.

After all, what do we really know about what is about to unfold in China, which has an economy that even its own leadership cannot fully understand? What do we know about the mind-set of the Japanese housewife who, as strange as it sounds, plays a huge part in the direction of the flow of the world's savings? What do we know about the accuracy of the accounting ledgers of even our largest, most trusted financial institutions or of the sophisticated financial instruments these firms deploy? What do we know about the long-term strategic implications of today's excess savings being controlled by nondemocratic governments? And what are the social and political implications of global wealth being so unevenly distributed?

In addition, the markets lack information about what may be the most critical issue of all—whether the trend of globalization itself will be allowed to continue. The politics of globalization are heating up fast as the anxiety produced by the power of free-flowing capital and goods skyrockets. Amazingly, a recent *Wall Street Journal*/NBC poll revealed that in the United States, by a two-to-one majority, even Republicans believe free trade is hurting America. The troubling turbulence of the subprime-driven Great Credit Crisis of 2007–2008 hasn't helped matters either. It is the latest rallying cry for the antiglobalization forces gathering on the horizon.

"Perhaps most troubling," I said as our lunch concluded, "is that most people today lack a historical perspective. The boom period is being taken for granted. Median-age American voters today were born in the mid-1960s. They have no recollection of the stagflation and long gas lines of the 1970s, the period before today's globalized economy. They have never known anything but a highly productive economy, with impressive stock markets and ample jobs. Many key constituencies of globalization have been lulled into complacency. Therefore, the period ahead will be one of potentially imprudent, overly reactive policy change.

"To top it all off," I stressed to Despres, "policymakers don't appreciate the fragile nature of today's global financial system and how financially induced prosperity can stealthily slip away through the unintended consequences of well-intentioned policy actions that attempt to legislate or regulate economic security. Today, we find ourselves in a situation in which the globalized financial system both enables and threatens our national well-being."

I concluded by suggesting that Friedman's book brilliantly presents the first installment of the globalization story, but there is a second installment as well—the financial side of the story. That's the subprime side where, for example, a small village in Arctic Norway can see its entire financial future destroyed because its financial managers invested heavily in a Citigroup product called a collateralized debt obligation. When the housing markets an ocean away in Florida and California collapsed, the debt obligations soured, and the Norwegian village had to shut down kindergartens and health care services for the elderly.

At the end of our conversation we turned to history, agreeing that nothing about the world's current political, economic, and financial predicament is new. Indeed, today's world economy bears a striking resemblance to the integrated markets and overwhelming prosperity of the period from 1870 to 1914, which noted economist John Maynard Keynes described as "an extraordinary episode in the economic progress of man." That, too, was a period punctuated by continual financial crises—and also of great prosperity. Ironically, today we ask the same questions as they did in 1914: What does it take to sustain this new, successful global economic system? What policymaking perils could reverse this wealth creation? Stagflation? Deflation? Protectionism? What unexpected financial explosion or implosion could create waves—curves—that the world remains unprepared to handle except through trade wars, strict capital controls, and other beggar-thy-neighbor policies—all policy blunders resulting from human error?

Today's industrialized world wants the Chinese to better manage their currency but remains unsure of the precise policy prescription or even of the capabilities of the conflicted Chinese leadership. The world hates America's twin budget and current account deficits, but no one has yet figured a safe way out of them. Nor does it seem like an answer will come any time soon. Much of the world's excess savings sits in the hands of nondemocratic regimes, led by China, and the oil producers, including Russia, but what this portends for the future, nobody knows. The Federal Reserve, in coming to the rescue of the investment firm Bear Stearns in March 2008, appears to have provided a government guarantee of the investments of the entire financial sector, not just the banks. The long-term implications for regulatory oversight, and thus the level of lending, under this new policy are anybody's guess. We live in a globalized world where we have to care much more about one another's problems, while simultaneously solving our own.

In his book, Friedman warns American policymakers of the need for tax credits, improved teachers' salaries, and novel approaches to creating, attracting, and retaining the new creators of value—the engineers. Yet retaining the free flow of capital to keep globalization's bloodstream pumping may also require the most sophisticated team of global financial brain surgeons. That is because the world today lacks a financial doctrine, or even much in the way of a set of informal understandings, for establishing order in a financial crisis. Instead, we have to grope and manage incrementally, like trying to perform delicate brain surgery with one hand tied behind our back and the other wearing an ill-fitting boxing glove. The financial markets have simply become too big, and at times too threatening, for our governmental institutions to be fully effective in maintaining stability.

The 1870–1914 period, eerily similar to what we face today, met a bitter new reality with the opening shots of World War I. Within a decade and a half, capital and trade flows collapsed, which helped set the stage for the Great Depression. Today one of the world's prominent global monetary policy theorists, and a governor of the Federal Reserve, Frederic Mishkin, argues ominously that "the possibility of another Great Reversal is very real." Martin Wolf of the *Financial Times* writes that "the breakdown of the early twentieth century occurred, in part, because of the pressures to accommodate rising powers in the global economic and political order." He suggests that today's rise of China and India will create comparable pressures—"a spiral of mutual hostility that undermines the commitment to a liberal international economic order."

Of course, the world won't cast some dramatic veto to end the current system as we know it. The industrial world financial markets have garnered too much political power for that to happen. Reversals seldom come in one cruel, visible, planned policy blow. Instead, like death from a thousand cuts, they come from a series of small, seemingly benign, but dangerously destabilizing changes that reach a terrifying tipping point of market uncertainty and fear. That is what happened during the subprime crisis, and today we are increasingly at risk of further financial calamities that threaten a vicious spiral of destruction and heartache.

I undertook the task of writing about this complicated system we call the new global economy because I have had a front-row seat, and probably played some modest role in its creation. Over my thirty-year career, I have watched the forces that created financial globalization unfold, and I have consulted regularly with some of the major players in the field of global finance. I feel obliged to share what I have learned with those who have not been afforded such access.

Over the years, I first served as the chief of staff to a senior member of the U.S. congressional leadership, and then as an adviser on economic issues to both Democratic and Republican presidential candidates. For the last twenty years, I have worked with some of the world's most successful money managers, including George Soros, Michael Steinhardt, Louis Bacon, Stan Druckenmiller, and Julian Robertson, through my global macroeconomic advisory firm Johnson Smick International (previously called Smick Medley and Associates). We serve as specialized quasi journalists—like a paid cable TV service compared with free network television.

In addition, I founded and continue to edit *The International Economy*, a magazine geared to the global central bank and finance ministry community. I also conceived and organized the U.S. Congressional Summits on the Dollar and Trade, a series of important conferences in the late 1980s and 1990s involving the world's finance ministers, central bankers, and the U.S. congressional leadership.

For two decades I have interacted daily with the most senior economists and most visible market traders on the front lines of financial globalization. They have all been grappling with the same issue: how to survive and prosper in this troubling new system.

In January 2007, more than six months before the outbreak of the subprime crisis, I commented one evening to the other guests at a Washington dinner party that "the average person today would be shocked to know how much the global financial system, though robust, faces a potential risk to its own survival. It is vulnerable to a psychological herd effect that could wreak havoc with the industrialized world economies." On the drive home from the dinner party, my wife, Vickie, remarked, "You should write a book on the subject. If the central bankers and Wall Street know what's behind the curtain, why shouldn't everyone else? Why don't you say what all the big money players already know about how these uncertainties could affect all of us?"

I therefore credit my smarter half for recognizing the need for such a book, and for providing the needed spark that motivated me to take on this project.