

# The crisis of failing strategies

Sovereign funds bring a profound shift in political and financial power, writes **Justin O'Brien**.

**T**he economic news from the United States continues to disappoint. As representatives of 40 powerful sovereign wealth funds gathered in Washington last week, the search for words to mask the pleading of global investment banking reached the nadir of credibility. The consequences of the calamitous deterioration of underwriting practices from late 2006 are made manifest by the downgrading of key mortgage provider Countrywide.

Countrywide, which has survived only because of a planned purchase by Bank of America, is trading at junk status. This follows a decision by its saviours to notify the Securities and Exchange Commission that it may not honour \$US38 billion (\$40 billion) in outstanding debt. A second leading provider, Residential Capital, is teetering on bankruptcy.

Foreclosures continue to soar, particularly for mortgages issued from 2006, a date widely recognised as the tipping point from mortgage approval probity to potential criminality. A federal taskforce has extended its investigation into lending practices at Countrywide and other providers. This has the effect of further dampening sentiment. It also calls into question whether the due diligence process will prompt Bank of America to walk away from the deal and the \$US1 billion it has already invested.

Investment bankers in New York say privately "there is no sense at which we are anywhere near the turning point in the credit crisis".

As the conflicts metastasise, the search for a global solution has become acute. Despite quick-fix solutions by the US Federal Reserve and other central banks, this short-term intervention cannot provide the market recapitalisation required.



**IMF managing director Dominique Strauss-Kahn with Australian Treasurer Wayne Swan in Washington last month.** Photo: YURI GRIPAS

The investment bankers make it clear that there is only one reliable source: sovereign wealth funds.

These funds form an increasingly important component of overarching macro-economic strategies in countries that have amassed the capital now required to subsidise Western binge spending.

Since January 2007, \$US60.7 billion of a total of \$US72.9 billion has been invested, primarily in the financial sector. As the credit crisis has intensified, so, too, has the pace of investment. In the first two months of 2008, \$US24.8 billion was dispersed. It signifies both the depth of the problem and the lack of credible policy and practical alternatives.

It is far from clear, however, whether the policy risks identified — financial contagion, the exercise of soft power, governance deficiencies — represent a pressing

danger or a thinly veiled attempt to justify economic protectionism. There is no evidence that these risks extend beyond the hypothetical. Policymakers in London and Brussels remark candidly, if privately, that the core dilemma is how to engage a resurgent Beijing.

It is against this background that 40 of the most influential SWFs gathered at the International Monetary Fund in Washington last week. The talks were aimed at generating a putative globally applicable code of conduct. They follow bilateral discussions between Abu Dhabi and Singapore with the US Department of Treasury and a second initiative advanced by the European Commission. There is growing recognition that some improvement in transparency is required, but it is also clear that this can be secured only by similar refinements to investment review

processes in recipient countries. The European Union and Australia have gone furthest in this regard. There is, however, an unacceptable degree of ambiguity in the proposals emanating from Brussels, Washington and Canberra. Each maintains political discretion over ill-defined "strategic interests".

The crisis in global markets requires an acceptance by recipient countries that financial liberalisation has generated players more adroit at playing global markets. This is not to suggest that power has migrated fully; rather, it is to argue that saving Wall Street requires recognising the failure of a losing geo-political and economic strategy.

■ **Justin O'Brien** is a professor at the (Australian) Centre for Applied Philosophy and Public Ethics and visiting professor at the University of New Hampshire.